(17)

No. 93-489-CFX Title: O'Melveny & Myers, Petitioner
Status: GRANTED v.
Federal Deposit Insurance Corporation as Receiver for American Diversified Savings Bank, et al.

Docketed:
September 27, 1993 Court: United States Court of Appeals for the Ninth Circuit

See also:
93-651 Counsel for petitioner: Smith,Gregory Radin

Counsel for respondent: Solicitor General, Russell,Theodore

Entry	Date	Note	Proceedings and Orders
1	Sep 27 1993	G	Petition for writ of certiorari filed.
2	Oct 26 1993		Brief of respondent Federal Deposit Insurance Corporation filed.
4	Oct 26 1993		Brief amicus curiae of Beus, Gilbert & Morrill filed.
3	Oct 27 1993		Brief amicus curiae of Burch & Cracchiolo, PA filed.
5	Oct 27 1993		Brief amicus curiae of Business Lawyers filed.
8	Oct 28 1993		Brief amicus curiae of Meyer, Hendricks, Victor, Osborn & Maledon, P.A. filed.
6	Nov 3 1993		DISTRIBUTED. November 24, 1993 (Page 2)
7	Nov 29 1993		Petition GRANTED.
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10	Jan 12 1994		Brief amicus curiae of Lee H. Henkel III filed.
9	Jan 13 1994		Brief amicus curiae of Banking and Business Lawyers filed.
11	Jan 13 1994		Brief amici curiae of Arthur Andersen & Co., et al. filed.
12	Jan 13 1994		Brief amicus curiae of American Bar Association filed.
13	Jan 13 1994		Joint appendix filed.
14	Jan 13 1994		Brief of petitioner O'Melveny & Myers filed.
15	Jan 13 1994		Brief amici curiae of Shrader & York, et al. filed.
18	Feb 2 1994		SET FOR ARGUMENT MONDAY MARCH 21, 1994. (1ST CASE).
20	Feb 3 1994		Order extending time to file brief of respondent on the merits until February 18, 1994.
21	Feb 9 1994		CIRCULATED.
22	Feb 16 1994		Record filed.
		*	Original proceedings U.S.Court of Appeals, Ninth Circuit and U.S.D.C., Central District of California (BOX)
23	Feb 18 1994		Brief amici curiae of Securities Investor Protection Corporation, et al. filed.
24	Feb 18 1994	X	Brief of respondents FDIC, et al. filed.
25	Mar 4 1994	X	Reply brief of petitioner O'Melveny & Meyers filed.
26	Mar 21 1994		ARGUED.

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93-489

No.——

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

O'MELVENY & MYERS, A LAW PARTNERSHIP,
Petitioner,
v.

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS PARK II, and AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether federal common law authorizes the Federal Deposit Insurance Corporation, suing as receiver of an insolvent savings bank, to pursue tort claims against third parties in situations where the bank itself would have been estopped from bringing suit.

2. Whether, in a lawsuit brought by the Federal Deposit Insurance Corporation as receiver of an insolvent savings bank, it is proper to use a federal rule of decision in determining what tort claims the bank would have had against third parties prior to the receivership.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner O'Melveny & Myers respectfully prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Ninth Circuit in this matter.[1]

[1] The sole parties to this case are reflected in the caption. The lawsuit was actually filed by the Federal Savings & Loan Insurance Corporation ("FSLIC"), but the designation of the plaintiffs was changed in 1990 to the Federal Deposit Insurance Corporation

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is reported at 969 F.2d 744, and is reprinted in the appendix hereto at 1a-16a. The decision of the United States District Court for the Central District of California is not reported. The court's oral ruling and subsequent order are reprinted in the appendix at 17a-19a and 20a-21a.

JURISDICTION

The Ninth Circuit issued its decision on June 29, 1992. A timely petition for rehearing was denied on June 30, 1993. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

None.

STATEMENT

This case involves a claim of legal malpractice brought against the law firm of O'Melveny & Myers ("O'Melveny") by the Federal Deposit Insurance Corporation ("FDIC") as receiver of the American Diversified Savings Bank ("ADSB"). It arose from work that was performed by O'Melveny for ADSB in late 1985, assisting in the preparation of two private placement memoranda for circulation to potential investors in real estate syndications. At that time, Ranbir Sahni, who was ADSB's Chairman and owned 96 percent of its stock, and Lester Day, who was the bank's President and owned the balance of the stock, were engaged with others in a fraudulent effort to hide the fact that ADSB was in precarious financial condition. That effort included intentional overvaluation of assets, sham sales of assets, and other financial irregularities. These facts were not disclosed to O'Melveny, however, and thus were not discussed in the private placement memoranda that the firm helped to prepare.

("FDIC"). For the sake of clarity and simplicity, we refer throughout this petition to respondent as the "FDIC."

On February 14, 1986, the FDIC stepped in as conservator for ADSB, removed Sahni, Day, and their fellow officers and directors, and installed new management. Within a few days, the FDIC sued Sahni and Day for over $70 million for fraud, misrepresentation, mismanagement, and breach of fiduciary duty. It thereafter caused ADSB to rescind the two private placements, repaying the sums previously invested. ADSB was liquidated in June 1988.

On May 12, 1989, the FDIC, acting as ADSB's receiver, filed suit against O'Melveny alleging legal malpractice and seeking damages on behalf of ADSB and the investors. First asserting a breach of duty to ADSB, the FDIC charged that O'Melveny should have discovered the true facts about ADSB's management and financial condition, and advised the bank of the bank's own fraud and the consequences that would flow from it. In addition, the FDIC asserted that O'Melveny breached a duty to the investors in the real-estate syndications by failing to disclose the problems at ADSB in the private placement memoranda.[2]

After the FDIC and O'Melveny agreed to a stipulated record (solely for the purposes of summary judgment), the United States District Court for the Central District of California granted summary judgment for O'Melveny. In a brief oral decision, the court ruled that O'Melveny had no duty to ADSB to discover and disclose to ADSB its own fraudulent activities, and that any claims the investors might have had (which were previously assigned to ADSB) were extinguished through repayment via the rescission.

[2] In the opinion below, the Ninth Circuit focused entirely on the FDIC's claim brought on behalf of ADSB, evidently because the investors had been fully repaid and the FDIC was "not seeking reimbursement for the rescission payments to the investors." Pet. App. 15a. Accordingly, petitioner here addresses only ADSB's claims.

The FDIC appealed. In the Ninth Circuit, O'Melveny contended that, since ADSB's controlling officers and directors and all of its shareholders had full knowledge of their own fraudulent efforts to conceal ADSB's real financial condition, and had attempted, successfully, to conceal those activities from O'Melveny, the law firm could not have been held liable to ADSB for failing to discover and disclose this fraud. The firm also argued that if ADSB had no cause of action, the FDIC could have no greater rights, since it was suing as the receiver of ADSB's claims and liabilities.

The Ninth Circuit reversed. To begin with, the court ruled that petitioner had a duty to discover its client's fraudulent activities. In such a situation, the court stated, a lawyer is required to "advise the client and the world" of the client's fraud. Pet. App. 7a. The court rejected the notion that a client's own intentional misconduct "cancels the attorney's duty to use due care" and to advise his client that its conduct will redound to its own detriment by causing public harm. *Id.* at 8a.[3]

The court then turned to the question whether ADSB would have been estopped from suing O'Melveny because its top officers and 100-percent owners were fully aware of their own fraudulent conduct. It held that estoppel did not apply. In so ruling, the court relied on a federal rule—citing principally federal cases applying federal law and the law of states other than California for the proposition that Sahni's and Day's conduct was sufficiently "adverse" to the interests of ADSB to prevent imputation of their knowledge to the bank. *Id.* at 12a ("[C]onduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit that corporation.").

Finally, the Ninth Circuit held, in the alternative, that any estoppel defense applicable to ADSB would not in any event be applicable to the FDIC. The court stated that "federal, not state, law governs the application of defenses against [the] FDIC." *Id.* at 13a (citing *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 456 (1942), and several lower court decisions). The court acknowledged that it was authorized to "incorporate state law to provide the federal rule of decision," *id.* at 13a-14a, but concluded, without explanation, that it "must instead establish federal law [here]," *id.* at 14a.

In fashioning its new federal rule, in turn, the court relied entirely on its own notions of "equity." *Id.* It pointed out that a receiver differs from a normal successor in interest, who takes over a bank's assets voluntarily and "can adjust the purchase price for the diminished value of the bank's assets due to their associated equitable defenses." *Id.* Providing a fiscal rationale for its new rule, the Ninth Circuit, after taking note of the "intricate [federal] regulatory scheme designed to protect the interests of third parties," held that the federal regulation of savings and loan institutions was "designed to protect the interests of third parties . . . [and] would be frustrated by imputing the bank's inequitable conduct to the receiver, thereby diminishing the value of the asset pool held by the receiver and limiting the receiver's discretion in disposing of the assets." *Id.* at 15a.

REASONS FOR GRANTING THE WRIT

The central issue in this case is whether federal common law grants the FDIC, acting as receiver of a failed savings bank, the right to pursue tort claims against law-

[3] This aspect of the Ninth Circuit's decision is not raised as a basis for this petition because it appears, at least arguably, to rest on California law. The court invoked "the general rule that a lawyer has to act competently to avoid public harm when he learns that his is a dishonest client" (Pet. App. 8a), and stated that "[n]o California cases advise us of an exception to th[is] general rule," *ibid.* The ABA's Working Group on Lawyers' Representation of Regulated Clients has called the Ninth Circuit's "general rule" a "novel theory" of attorney malpractice. *See Laborers in Different Vineyards? The Banking Regulators and the Legal Profession* 129-30 (Discussion Draft, Jan. 1993).

yers previously retained by the bank, based on the theory (not available to the bank under state law) that these lawyers should have discovered the fraud and disclosed it to the perpetrators of the fraud—the bank's own controlling officers and directors. The Ninth Circuit, applying newly created federal common law rather than borrowing the applicable state law concerning the rights of receivers, ruled that the FDIC could pursue such a claim against O'Melveny, even if ADSB itself would have been estopped from doing so. The court also held in the alternative, adopting a federal rule of decision drawn largely from federal RICO cases, that the bank itself would not have been estopped from bringing such a claim, because the knowledge of its owners and managers would not have been imputed to the bank as a corporate entity.

These rulings warrant review by this Court for two reasons. First, as the FDIC has acknowledged, the Ninth Circuit's decision here and the Fifth Circuit's decision in *Ernst & Young*, 967 F.2d 166 (1992)—the leading cases in this area—are squarely in conflict. That conflict involves an issue of critical legal and practical importance —the manner in which federal courts are to address third-party tort liability claims in the wake of bank failures. Immediate resolution of this circuit conflict is essential, because courts all over the country are now faced with the question of what law to apply in deciding whether to allow the FDIC to proceed with massive tort claims against accounting and law firms previously retained by failed banks and savings institutions. *See, e.g.*, Adams, *Thrift Litigation Fallout; Suits Increasing; Firm Grip on Lawyers Sought*, N.Y. L.J., June 18, 1992, at 5; Boyle, *FDIC Steps Up Probes of Lawyers*, Mass. Law. Wkly., Mar. 25, 1991, at 1. A central threshold issue in these cases will be the extent to which the FDIC's involvement can breathe life into tort claims that a bank otherwise could not have brought.[4]

[4] This important conflict has already prompted substantial legal commentary. *See, e.g.*, Sontag, *Circuits Split on Regulators' S&L Malpractice Claims*, Nat'l L.J., Aug. 17, 1992, at 17 ("Conflicting decisions from the 9th and 5th Circuits have left regulators and professionals who advise the banking industry uncertain over the viability of malpractice claims when the federal government becomes a receiver. . . . With so many failed [financial] institutions in Texas and the Pacific northwest, the battle is likely to affect the outcome of dozens of pending and future cases."); Arnoff & Klampert, *Regulatory Malpractice and Causation Analysis—Part I*, N.Y. L.J., Oct. 29, 1992, at 3 ("[The] two federal courts cases indicate a conflict in the circuits that may be resolved by the United States Supreme Court . . ."); Dennis & Fabrizio, *No Place to Hide*, The Recorder, Oct. 19, 1992 at, 10, 11 ("Without making reference to . . . *O'Melveny* . . ., the Fifth Circuit addressed the same issue—and came to the opposite conclusion."); *Laborers in Different Vineyards, supra*, at 124 ("Perhaps the most significant development in the area of malpractice litigation brought by the FDIC and RTC against attorneys is the position recently taken by the FDIC in several different cases on the question of which rule of decision—state law or federal common law—applies in such litigation.").

Second, the Ninth Circuit's approach in this case was fundamentally wrong. The court had no justification for applying judge-made federal common law to decide this case, in complete disregard of well-developed principles of state tort law that had previously formed the basis of the relationship between a law firm and its client.[5] It is true that cases involving the FDIC are "deemed to arise under the laws of the United States," 12 U.S.C. § 1819(b)(2),

[5] *See Laborers in Different Vineyards, supra*, at 123-24 ("the new liability theories [of the FDIC and RTC] strain or ignore established principles and parameters of the attorney-client relationship . . . . Under some of the theories, counsel would appear to have responsibilities not only to their institutional client but also unprecedented responsibilities to the government regulators and the public at large. The new liability theories are sometimes advanced by the agencies under the rubric of 'federal common law' as a means of overcoming established state law and precedents allowing imputation to a bank (and, by extension, to the federal regulatory agency as its successor-in-interest) the wrongdoing of bank officers, directors, and shareholders. By avoiding such imputation, the federal receivers are able to foreclose the availability of traditional malpractice defenses such as fraud and contributory negligence.") (footnote omitted).

but that does not mean that courts are free to create new federal common law in deciding every issue. Rather, under this Court's precedents, the lower federal courts are presumptively required, for reasons of federalism and stability in the law, to borrow the applicable rule of state law. *See, e.g., Kamen v. Kemper Fin. Servs., Inc.,* 111 S. Ct. 1711, 1717 (1991).

Here, California law plainly provides that a receiver has no greater rights than the predecessor entity. California courts, in turn, would also hold that, under state law, ADSB was estopped from suing O'Melveny. If these rules were applied to this case, the FDIC's claim would be barred. But the Ninth Circuit did not bother even to ascertain the applicable state law—instead proceeding directly to apply its own preferred *federal* rules of decision in resolving both of these issues. *See* Pet. App. 13a. ("The flaw in [O'Melveny's] argument is the law O'Melveny assumes applies.").

It did so, moreover, without a convincing demonstration that these uniform federal rules were required to promote any unique federal interests. Stripped to its essence, the Ninth Circuit's analysis reflects little more than an explicit commitment to maximizing the funds recovered by the FDIC from every available party. *See* Pet. App. 15a ("imputing the bank's inequitable conduct to the receiver . . . [would] diminish[] the value of the asset pool held by the receiver"). But that can hardly be a sufficient basis for a ruling that, by "federalizing" tort law, dramatically altered O'Melveny's legal position after the fact. The conduct of attorneys, it is well recognized, is principally a matter of concern to the sovereign that licenses them and the state judiciary that supervises them. *Cf. Goldfarb v. Virginia State Bar,* 421 U.S. 773, 792 (1975). Yet, at least in the area of banking, the Ninth Circuit has fundamentally altered the legal responsibilities that lawyers have to their clients in a way that will directly affect their day-to-day practice. This Court should rebuff

such federal excursions into an area where "private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards." *Kamen,* 111 S. Ct. at 1717.

I. THE DECISION BELOW SQUARELY CONFLICTS WITH RULINGS FROM THE FIFTH CIRCUIT.

The Ninth Circuit's rulings in this case conflict directly with the Fifth Circuit's decision in *FDIC v. Ernst & Young,* 967 F.2d 166 (1992), which was later followed in *FDIC v. Shrader & York,* 991 F.2d 216, 221-26 (5th Cir. 1993). The FDIC expressly acknowledged the conflict in its rehearing petitions in both *Ernst & Young* and *Shrader & York.* FDIC's Suggestion for Rehearing *In Banc* [in *Ernst & Young*], at 10 (the "panel's holding [in *Ernst & Young*] places the opinion in direct conflict with the Ninth Circuit's recent opinion in *O'Melveny*"); FDIC's Petition for Rehearing [in *Shrader & York*], at 6 ("The panel's holding [in *Shrader & York*] is in direct conflict with the Ninth Circuit's opinion in *O'Melveny.*"). This conflict, which extends to both of the issues raised in this petition, needs to be resolved by this Court.

A. The existence of the conflict is clear and, as noted, undisputed. The Ninth Circuit held that the FDIC is not barred by a state-law estoppel defense that would have prevented a failed savings bank from suing its own former counsel. Implicitly acknowledging that a receiver under California law has no greater rights than were possessed by the corporation prior to receivership, the court nevertheless held that it was not "bound" to apply state law in determining the FDIC's rights. Pet. App. 14a. Then, citing little more than its own notions of "equity" and a policy of maximizing the FDIC's fisc, the court proceeded to establish a new federal rule exempting the FDIC from a defense that would have barred a suit against O'Melveny by ADSB. *Id.* at 14a-15a.

In *Ernst & Young,* by contrast, the Fifth Circuit expressly rejected the FDIC's argument that, when it acts

as receiver of a failed financial institution, federal common law allows it to assert tort claims that would have been unavailable to that institution prior to the receivership. The court refused to conclude that the FDIC is "entitled to special protection when it brings a tort claim against a third party on behalf of a defunct financial entity," explaining that "[n]o statutory justification or public policy exists to treat the FDIC differently from other assignees" of claims previously possessed by financial institutions. 967 F.2d at 170.

The Ninth Circuit's alternative holding—that the estoppel defense would not even have applied to ADSB itself, prior to the receivership, and thus cannot bar suit by the FDIC—is also irreconcilable with *Ernst & Young*. The primary reason, here again, is that the Ninth Circuit chose to disregard settled state-law principles. The FDIC has repeatedly insisted—both in the Ninth Circuit and in the Fifth Circuit—that federal law governs this issue. *See* pp. 12-13 *infra*. And, while the text of the *O'Melveny* opinion is not altogether clear, the fairest reading is that, in deciding whether the knowledge of the two shareholders and officers of ADSB should be imputed to the savings bank itself, the court acepted the FDIC's invitation and applied a *federal* rule of decision, rather than borrowing the state rule.

This reading is supported by the fact that the court gave scant attention to the relevant California decisions, choosing instead to rely primarily on *Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983), a RICO case applying federal common law to this question,[6] and on other federal cases from other circuits that applied the law of other states. Pet. App. 11a-12a. The court did cite one California case, along with several non-California cases, when it articulated the nearly

[6] The court stated that the *Schacht* decision had been "followed by this Circuit" in another RICO case, *Kempe v. Monitor Intermediaries, Inc.*, 785 F.2d 1443, 1444 (9th Cir. 1986). Pet. App. 12a.

universal rule that the knowledge of a corporate officer is not imputed to the corporation where the agent is acting adversely to the principal. Pet. App. 11a. But when it then turned to the specific problem of how that universal rule applies here—*i.e.*, whether the top officers of a savings bank are treated as benefiting or injuring that bank when they engage in "conduct aggravating [the bank's] insolvency and fraudulently prolonging its life"—the court made no reference whatsoever to California law. *Id.* at 12a.

Had it done so, the court would have had to take note of the distinction drawn in California decisions between (1) cases where an agent defrauds the principal (and no imputation applies) and (2) cases like this one where an agent, for his own benefit, defrauds *third parties* on behalf of the principal (and imputation does apply).[7] *Compare Meyer v. Glenmoor Homes, Inc.*, 54 Cal. Rptr. 786, 801 (Ct. App. 1967) ("A corporation is not chargeable with the knowledge of an officer who collaborates with an outsider to defraud it."), *with West American Fin. Co. v. Pacific Indem. Co.*, 61 P.2d 963, 969 (Cal. Ct. App. 1936) (noting that an officer acting for a corporation in a transaction, even if he has an opposing personal interest, has a duty to communicate material facts to the corporation and holding that, "[i]n such case the law will presume in favor of third persons that he made such communication; and it is immaterial that he took some personal benefit from the fraud"). The Ninth Circuit did not even acknowledge this dispositive state-law distinction, nor did it otherwise indicate that it was attempting to ascertain, and borrow, California law.

[7] The troubling nature of the court's analysis is underscored by the fact that another panel of the Ninth Circuit has held, in a case also involving the FDIC, that the defrauding owners of ADSB were the bank's alter egos. *See California Union Ins. Co. v. American Diversified Sav. Bank*, 948 F.2d 556 (9th Cir. 1991).

The FDIC, for its part, both recognized that the Ninth Circuit based its ruling on federal law and argued that it was correct in so doing. Specifically, in opposing rehearing in *O'Melveny*, the FDIC defended the panel decision on the question of imputation of the officers' knowledge to ADSB, in these terms:

> *As this Court correctly found, federal law governs.* It is the law of the Circuit, as held in *Kempe v. Monitor Intermediaries*, 785 F.2d 1443 (9th Cir. 1986), that imputation is to be determined under the test of *Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983). This Court correctly applied the *Schacht* test in this case and held that the wrongdoing of two individuals should not be imputed to ADSB.

FDIC Response to Petition for Rehearing and Suggestion for Rehearing En Banc, at 4 (October 5, 1992) (emphasis added). Given that view, coupled with the language of the opinion, the Ninth Circuit's imputation/estoppel ruling is properly interpreted as having been based on federal law. *Cf. Michigan v. Long*, 463 U.S. 1032 (1983) (requiring state courts to include a clear statement that a decision is based solely on state law before Supreme Court will conclude that it rests on an adequate and independent state ground).

The Fifth Circuit in *Ernst & Young*, by contrast, clearly applied *Texas* law in determining the imputation/estoppel issue.[8] It thus concluded that any negligence exhibited

[8] In one brief filed in *O'Melveny*, the FDIC took the Fifth Circuit to task for applying state, rather than federal, law to this issue in *Ernst & Young*. *See* FDIC Response to Petition for Rehearing and Suggestion for Rehearing En Banc, at 3-4. ("The Fifth Circuit's imputation analysis also ignored the fact that federal—not state—law applies to the FDIC. . . . Although the *Schacht* case was extensively briefed to the Fifth Circuit, that Court failed even to refer to it.").

by Ernst & Young in performing its audits was not actionable because, under Texas law (like California law), knowledge of the bank's true financial condition possessed by the bank's sole shareholder was properly imputed to the bank itself (and ultimately to the FDIC as the bank's receiver). 967 F.2d at 170-71 ("In Texas, whether an employee's fraud is attributable to a corporation depends on whether the fraud was on behalf of the corporation or against it.")[9]

These conflicts between the Fifth and Ninth Circuits were, if possible, made even sharper when the former court issued its decision in *Shrader & York*. That case, like this one, involved a claim of legal malpractice against a law firm involved in various transactions on behalf of a savings and loan association that later failed and went into receivership. As in this case, but unlike in *Ernst & Young*, the FDIC purported to sue not only on behalf of the failed bank but also on behalf of depositors and creditors. *See* 991 F.2d at 223. But the Fifth Circuit once again held that the FDIC stands in the shoes of the savings banks for purposes of application of any defenses based on the imputed knowledge of the prior owners and officers. *Id.* at 222-23. And it again applied Texas law in determining that, on the facts presented, such knowledge should indeed be imputed to the savings banks and, derivatively, to the FDIC. *Id.* at 223-27.

Finally, we note that there appears to be a partial conflict between the decision below and relevant decisions of the Tenth Circuit. That court has now twice held, albeit without extensive analysis, that the rights of the FDIC as plaintiff are no greater than the rights that would

[9] In both *Ernst & Young* and *Shrader & York* the FDIC argued that because "[t]he national deposit insurance program presents a uniquely federal interest," federal law should govern whether the pre-takeover conduct of officers is imputed to the bank. FDIC Appellant's Brief in *Ernst & Young* at 22 n.9; *see* FDIC Appellant's Brief in *Shrader & York* at 26 n.22.

have been available to the bank prior to the receivership. *See FDIC v. Clark*, 978 F.2d 1541, 1550 (10th Cir. 1992) ("The [district] court properly instructed that if an employee was acting within the scope of his authority then his fault would be attributed to the FDIC, standing in the shoes of the bank."); *FDIC v. Ferguson*, 982 F.2d 404, 407-08 (10th Cir. 1991) ("Home [Savings and Loan Association] originally instituted this action when it was solvent, when the case was simply one between an attorney and his client. The FDIC's stepping in after nearly three years of litigation, asserting the taxpayers' loss as guarantor of insured deposits, does not transfer the case into the realm of the public interest.") That view is inconsistent with the Ninth Circuit's holding that the FDIC has greater rights than the bank itself.

B. These conflicts warrant review by this Court. There are literally hundreds of similar lawsuits by the FDIC pending in federal courts around the country. The district courts have already begun to choose sides between the Ninth Circuit's view in *O'Melveny* and the Fifth Circuit's view in *Ernst & Young* and *Shrader & York* with respect to the FDIC's authority to bring claims that would not have been available to the financial institution prior to receivership.[10] As a practical matter, moreover,

[10] District courts following or anticipating the Fifth Circuit's approach include *RTC v. Deloitte & Touche*, Civil No. 3-92-90, [May 28, 1993] 2 Bank Lawyer Liability (Buraff) at G-45 (D. Minn. May 7, 1993); *FDIC v. Thompson & Knight*, 816 F. Supp. 1123, 1128-29 (N.D. Tex. 1993); *FDIC v. Gantenbein*, 811 F. Supp. 593 (D. Kan. 1992); *FDIC v. Regier, Carr & Monroe*, No. 92-072-S, 1992 U.S. Dist. LEXIS 14564 at *8 (E.D. Okla. Aug. 17, 1992), *aff'd on other grounds*, 996 F.2d 222 (10th Cir. 1993); *FDIC v. Cherry, Bekaert & Holland*, 742 F. Supp. 612, 613-15 (M.D. Fla. 1990); *FDIC v. Clark*, Civil Action No. 88-F-647, 1989 U.S. Dist. LEXIS 17556 (D. Colo. March 23, 1989).

District courts relying on and following the Ninth Circuit's approach in *O'Melveny* include *RTC v. Farmer*, 823 F. Supp. 302, 311-12 (E.D. Pa. 1993); *In re Sunrise Sec. Litig.*, 818 F. Supp. 830, 836-40 (E.D. Pa. 1993); *FDIC v. Benjes*, 815 F. Supp. 1415, 1417-18 (D. Kan. 1993); *Comeau v. Rupp*, 810 F. Supp. 1127, 1137-44 (D. Kan. 1992); *FSLIC v. McGinnis, Juban, Bevan, Mullins & Patterson, P.C.*, 808 F. Supp. 1263, 1272-75 (E.D. La. 1992).

the choice made by each of these courts is "crucial, especially because the ability to sustain or thwart motions for summary judgment in banking cases often decides the outcome." Sontag, *supra*, at 17.

There is no possibility that this conflict will ameliorate or dissipate. Its existence has been brought to the attention of both the Fifth and the Ninth Circuits in rehearing filings, and neither court has shown any inclination to reconsider its rulings. And the FDIC, which is a party to all of these cases, is sure to press its expressed view that the Ninth Circuit correctly decided both disputed issues on the basis of federal law, and that those federal law rulings—rather than the Fifth Circuit's state law holdings—should be followed in all FDIC cases. Finally, as we discuss in the next section of this petition, there are persuasive reasons for concluding that the Ninth Circuit's ruling is fundamentally misguided, and will have unfortunate consequences in those jurisdictions where it is applied. The legal relationship between attorney and client is a core matter for state law to control, and that law should not be displaced by federal law simply because the federal courts either do not like the state law rule or see a need to enhance the FDIC's ability to obtain funds from all parties who were ever retained by banks that subsequently failed.

II. THE NINTH CIRCUIT'S RULINGS MAKE NO SENSE AND WILL HAVE PERNICIOUS CONSEQUENCES.

On the merits, it is difficult to defend the Ninth Circuit's decision in this case. It rests largely on a transparent attempt to locate an additional "deep pocket" to help cover the government's obligations as insurer of the bank-

ing and thrift industries.[11] In pursuit of that goal, the court of appeals (1) adopted a very expansive understanding of the "duty" owed by counsel to a client institution, (2) determined under federal law that this duty could have been enforced by ADSB, and (3) held that, in any event, under its newly fashioned federal common law, the FDIC is exempt from state-law defenses that would have applied to ADSB. In essence, the court took the position that state law becomes irrelevant whenever it impairs the uniform federal interest in maximizing the FDIC's recoveries from third parties.

The problems with the Ninth Circuit's decision have not gone unnoticed. Commentators have expressed both criticism of the Ninth Circuit's legal analysis and great concern about the practical effects of this ruling. *See* Hazard, *Ethics*, Nat'l L.J., Aug. 3, 1992, at 15, 17 ("The[] possibilities [suggested by *O'Melveny*], if they are fulfilled, would put the Kaye Scholer contretemps into the shade."); Arnoff et al., *supra* (Ninth Circuit's "analysis is critically flawed"); Brodsky, *Accountant's Liability: Erasing History*, N.Y. L.J., Mar. 11, 1993, at 3 (*Ernst & Young* is "a common-sense, well principled decision contradicting *O'Melveny & Myers*"); Brodsky, *Liability of Attorneys*, N.Y. L.J., Oct. 14, 1992, at 3 ("[T]he [Ninth Circuit] decision . . . is result oriented," with the outcome hinging "upon the identity of the plaintiff rather than the merits of the case"); Donovan, *ABA Task Force Pushes for Freeze on OTS' Powers*, Nat'l L.J., Feb. 22, 1993, at 17 ("The regulators [as a result of O'Melveny] 'want essentially to deputize the private bar' as their investigators") (quoting member of ABA Task Force).

[11] *See Laborers in Different Vineyards*, *supra*, at 124-25 ("The FDIC as receiver has . . . argued in several circuits that the courts should reject state law and, instead, create federal common law because such a rule of decision 'best serves the Congressional goal of maximum recovery for the FDIC.'") (footnotes omitted).

These important concerns should be addressed by this Court.

A. With respect to the question whether the FDIC is immune from application of an estoppel defense that would have applied to ADSB, the Ninth Circuit was, of course, correct in holding that this is a federal *question*. Pet. App. 13a-14a. *See* 12 U.S.C. § 1819(b)(2) (providing that cases to which the FDIC is a party are "deemed to arise under the laws of the United States"). But that does not mean that the court was correct in going ahead and fashioning a unique federal rule of decision. This Court has made clear that, in applying federal common law, the lower courts should adopt uniform federal rules only "when the scheme in question evidences a distinct need for nationwide legal standards," or when Congress has made the applicable policy decision itself in an analogous statutory scheme. *Kamen v. Kemper Financial Servs., Inc.*, 111 S. Ct. at 1717 (citing cases). "Otherwise, . . . federal courts should 'incorporat[e] [state law] as the federal rule of decision,' unless 'application of [the particular] state law [in question] would frustrate specific objectives of the federal programs.'" *Ibid.* (quoting *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979)). And the "presumption that state law should be incorporated into federal common law is particularly strong in areas in which private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards." *Kamen*, 111 S. Ct. at 1717.

Here, there is no justification for a special national rule governing the right of the FDIC to bring malpractice suits against law firms that represented failed savings banks. Such lawsuits at their heart involve the lawyer-client relationship, which is a matter chiefly of concern to the individual states. No policy reflected in any pertinent federal statute suggests that there is an overriding federal interest in assuring national uniformity in this

area. Nor, more specifically, can it be said that it would frustrate achievement of federal objectives to follow the California rule that "[a] receiver occupies no better position than that which was occupied by the . . . party for whom he acts . . . and any defense good against the original party is good against the receiver." *Allen v. Ramsay*, 4 Cal. Rptr. 575, 583 (Ct. App. 1960). That, after all, is the usual rule, reflected in numerous federal cases holding that the FDIC merely "stands in the shoes" of a failed bank. *See FDIC v. Ernst & Young*, 967 F.2d at 169-70 (citing cases).

The Ninth Circuit simply ignored this straightforward, traditional analysis and chose instead to fashion its own rule, based on its notions of "equity." To support its approach, the court reflexively cited the decision in *D'Oench, Duhme & Co.*, where this Court applied federal common law in holding that the FDIC is not bound by secret side agreements between banks and borrowers. But the justification for federalizing the law in the *D'Oench, Duhme* context is inapplicable here. The key federal policy underlying that decision—the need to preserve the FDIC's ability to rely on a bank's records in making often hasty evaluations of bank assets, *see Langley v. FDIC*, 484 U.S. 86, 91 (1987)—has no relation to a case involving a potential tort claim that a bank never asserted.[12] In short, the *D'Oench, Duhme* doctrine has no more relevance here than it had in the numerous analogous cases where courts have rejected the FDIC's efforts to displace well-settled state law defenses in favor of a more accommodating federal rule. *See, e.g., FDIC v. Aetna Casualty & Sur. Co.*, 947 F.2d 196, 201-09 (6th Cir. 1991) (finding state law applicable against FDIC on insurer's defenses of adverse agency, fraud in the

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[12] Obviously, unlike in *D'Oench, Duhme* where there was an issue of the FDIC's reliance on a fixed, contractually based asset, here the FDIC could not have relied on the specific value of a potential tort claim against O'Melveny.

inducement and alter ego); *FDIC v. Bowles Livestock Comm'n Co.*, 937 F.2d 1350, 1353-56 (8th Cir. 1991) (holding FDIC may not "trump the ordinary operation of state laws"; state law defenses "control[] as the source of the federal law in this case"); *FDIC v. Harrison*, 735 F.2d 408, 412 (11th Cir. 1984) ("We see no reason not to apply the traditional rules of equitable estoppel to the conduct of FDIC in this case.").

In fact, as the Ninth Circuit's own decision reflects, there is no policy that would justify exempting the FDIC from most defenses previously applicable to a failed bank, other than a naked desire to maximize the assets available to the FDIC. *See* Pet. App. 15a (citing need to avoid "diminishing the value of the asset pool held by the receiver"). That can hardly be enough, in the complete absence of congressional action, to override the usual rule supplied here by state law—the rule that a receiver inherits the rights and liabilities of the entity that is taken over. Were it sufficient, all state-law impediments to maximizing the FDIC's recovery—*e.g.*, statutes of limitations, laches, comparative fault—would be swallowed by this asset-maximization policy.

This conclusion is particularly compelling given the consequences of ignoring state law in these circumstances. The clear effect of the Ninth Circuit's decision is a retroactive impact on the relationship between lawyers and their clients. Thus, even assuming that O'Melveny could have anticipated the Ninth Circuit's rather novel conclusion that California law required it to take all reasonable steps to discover its clients' fraudulent activities and to disclose that fraud to the client, the law firm would also have known that the client itself—*i.e.*, the bank—was barred from bringing a tort suit charging a breach of any such duty. Suddenly, however, as soon as the FDIC acquired ADSB's rights and liabilities, according to the Ninth Circuit, O'Melveny's defense evaporated.

This is not a sensible way for the federal scheme to operate. *See United States v. Kimbell Foods, Inc.*, 440 U.S. at 728-29 ("[O]ur choice-of-law inquiry must consider the extent to which application of a federal rule would disrupt commercial relationships predicated on state law."). At minimum, it should be up to Congress to make the kinds of pure policy determinations that evidently motivated the Ninth Circuit in this case to stretch to find a way to enrich the FDIC's coffers by allowing this action to proceed.

B. The Ninth Circuit went even further astray when it failed to focus on California law in rendering its alternative holding that even ADSB would not have been estopped from suing O'Melveny. Assuming (contrary to the Ninth Circuit's other main holding) that the FDIC does "stand in the shoes" of the failed bank, then a determination of the FDIC's rights requires the court to posit a lawsuit between the bank and its former counsel. In such a lawsuit between two private parties, there would be no basis for preempting state tort law and applying *federal* estoppel principles. Certainly the mere prospect of later FDIC involvement cannot mean that all of a bank's dealings with lawyers and other third parties affect "uniquely federal concerns" justifying displacement of state law in litigation between such private parties. *See Boyle v. United Technologies Corp.*, 487 U.S. 500, 504-07 (1988); *Miree v. DeKalb County*, 433 U.S. 25, 32-33 (1977).

It follows that, when the FDIC does become involved in litigation as the receiver of a failed savings bank, state law should still be applied in determining what rights the bank had prior to the receivership. It would make no sense to adopt a rule that the FDIC inherits the rights and liabilities of the bank and then to apply a special federal rule of decision to determine retroactively what those rights and liabilities were. In sum, when the Ninth Circuit sought to establish what rights ADSB would have

had in a suit against petitioner, there was no justification for resolving that question on the basis of anything other than California law, which guided O'Melveny during its employment and will continue to guide other California lawyers while their bank clients are solvent. California law unmistakably provides that ADSB could not pursue an action against O'Melveny.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

No. 90-55769

FEDERAL DEPOSIT INSURANCE CORPORATION, as Receiver; AMERICAN DIVERSIFIED SAVINGS BANK; ADC FINANCIAL CORP.; AMERICAN DIVERSIFIED WELLS PARK III, *et al.*,
Plaintiffs-Appellants,

v.

O'MELVENY & MYERS,
Defendant-Appellee.

Appeal from the United States District Court
for the Central District of California

Argued and Submitted July 12, 1991

Decided June 29, 1992

Before: POOLE, KOZINSKI, and LEAVY, Circuit Judges.

POOLE, Circuit Judge:

The Federal Deposit Insurance Corporation ("FDIC"), as receiver for the failed savings and loan association American Diversified Savings Bank ("ADSB"), sued the law firm of O'Melveny & Meyers ("O'Melveny" or "the Firm") claiming professional negligence in connection

with its legal advice and services to ADSB. After reviewing *de novo* the district court's grant of O'Melveny's summary judgment motion, we reverse and remand to the district court for further proceedings.

I

Facts and Procedural History [1]

ADSB was acquired in 1983 by Ranbir Sahni and Lester Day. Sahni served as Chairman and Chief Executive Officer of ADSB, and Day was its President. ADSB's principal activity was the purchase, development and sale of real estate through limited partnerships sponsored by ADSB and its subsidiaries. These activities were funded by ADSB's insured deposits, which totaled $958 million by December, 1985. ADSB's deposits were insured by what was then known as the Federal Savings and Loan Insurance Corporation ("FSLIC").[2]

In September, 1985, ADSB retained O'Melveny, one of the largest and most prominent law firms in the country, to assist with two real estate syndications, Wells Park and Gateway Center. O'Melveny undertook that assistance in the preparation of two "Private Placement Memoranda" ("PPMs"), 300-page documents designed to induce outside investors to become limited partners in the two real estate deals. O'Melveny is described in the Wells Park and Gateway Center PPMs "as special counsel . . . to the General Partner and its Affiliates in connection with Federal Securities laws, Federal income tax law, and certain other matters." [Stip. ¶ 133; Exh. 65, 67.] O'Mel-

[1] Since this is an appeal from a summary judgment order, the facts have not been developed at trial. However, the parties have stipulated to certain facts. Disputed factual assertions are noted.

[2] The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, Pub.L. No. 101-73, 103 Stat. 183 (1989), abolished the FSLIC and transferred its liabilities and assets to the FSLIC Resolution Fund, of which FDIC is the manager. *Id.*, § 401(a)(1); § 215(a). FDIC was substituted as a party to this case under FIRREA § 401(f)(2). The federal regulatory agency is referred to hereinafter as "FDIC."

veny wrote substantial portions of the PPMs, edited other portions and performed a due diligence review to confirm the accuracy and completeness of the PPMs' disclosures.[3]

The parties dispute whether the PPMs indicated that the success of the projects was linked to the financial and regulatory health of ADSB, and the extent to which they represented that ADSB was in sound financial and regulatory condition. There is no dispute, however, that ADSB's financial condition was in fact far from sound. The parties agree that Sahni, Day and Wyn Pope, Executive Vice President of ADSB, had intentionally and fraudulently over-valued ADSB's assets, engaged in the sham sale of assets in order to create inflated "profits," and generally "cook[ed] the books." [Stip. ¶¶ 74, 75, 94, 95, 216; Exhs. 32, 100, 101.]

In April, 1985, ADSB's officers had decided to terminate Touche, Ross & Co. as the corporation's auditor, alleging publicly that the accounting firm was "too expensive." [Stip. ¶¶ 65, 66, 71.] ADSB replaced Touche Ross with Arthur Young & Company. By October, 1985, Arthur Young began to express concerns about ADSB's financial condition. ADSB engaged yet a third accounting firm, Coopers & Lybrand, to review the Gateway Center offering. On May 3, 1985, more than five months before the private placement offerings were sold to the investor, Touche Ross had notified ADSB, Rogers & Wells (then ADSB's attorneys), and federal regulators that they believed ADSB's net worth was less than zero.

[3] The parties disagree about the precise capacity in which the Firm was h[illegible] O'Melveny argued on appeal that "special counsel" meant tax counsel and not securities counsel. FDIC offered the Declaration of Jerry W. Carlton, O'Melveny partner and "primary partner contact" with ADSB, to support FDIC's contention that the "special counsel" role encompassed substantial assistance with the preparation of the PPMs as well as tax opinions.

In September, 1985, Rogers & Wells determined that up-to-date audited financial statements for ADSB were necessary for the "Hickory Trace" Offering, a private placement it was then preparing. Audited statements were never prepared, that particular private placement never closed, and ADSB completed the transfer of its business from Rogers & Wells to O'Melveny.

In the course of preparing the Gateway Center PPM, O'Melveny never communicated with Arthur Young, Touche Ross, Rogers & Wells, or ADSB's federal or state regulators. Nor did O'Melveny ever communicate with Day, Pope or James Miller, ADSB's Chief Financial Officer. Indeed, Arthur Young was not aware that O'Melveny had included Arthur Young's March 31, 1985 audited financial statement, by then almost six months out of date, in the Gateway Center PPM. The Wells Park and Gateway Center offerings closed on December 31, 1985.

On February 14, 1986, FDIC stepped in as conservator for ADSB, having concluded that ADSB was insolvent and that the corporation had incurred a substantial dissipation of assets and earnings due to its violations of laws and regulations and its unsafe and unsound business practices. On February 19, 1986, FDIC, as conservator for ADSB, filed a lawsuit in the Central District of California alleging breach of fiduciary duty against Sahni and Day, and RICO violations against Sahni.

Shortly after FDIC took over, it began receiving complaints from investors claiming they had been misled by the PPMs and demanding the return of their investments. FDIC, having made its own finding that the PPMs were misleading, offered to have the partnerships that controlled Wells Park and Gateway Center rescind the investments. The rescission was funded by a loan from American Diversified Capital Corporation (ADCC), a wholly-owned subsidiary of ADSB, to the offering partnerships. In accepting the rescission offer, each investor

assigned to FDIC "all actions, causes of actions, claims, or suits of any kind or nature whatsoever against any person or entity arising from the Initial Offering. . . ." [Offer of Rescission, Exh. 99] On May 12, 1989, FDIC commenced this suit against O'Melveny, charging the Firm with professional negligence, negligent misrepresentation, and breach of fiduciary duty.

At a settlement conference, the parties agreed to stipulate to a single set of facts and to test their legal claims in a summary judgment motion. O'Melveny argued before the district court that (1) it owed no duty to ADSB or its affiliates to ferret out ADSB's own fraud; (2) the conduct of ADSB's wrongdoing officers must be imputed to ADSB, and that FDIC, as receiver, stood in the shoes of ADSB; (3) and that therefore, as an ordinary assignee, FDIC was barred from pursuing any claims against O'Melveny. O'Melveny also argued that the investors' claims had been extinguished by repayment and that the investors' claims were barred by California's statute of frauds. The district court, specifying only that it perceived the existence of no genuine issue of material fact, granted O'Melveny's motion for summary judgment. FDIC appealed. We reverse.

II

Standard of Review

A trial judge should grant summary judgment under Fed.R.Civ.P. 56(c) if "there is no genuine issue as to any material fact and . . . the moving party is entitled to judgment as a matter of law." *Id.; see also Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249, 106 S.Ct. 2505, 2510, 91 L.Ed.2d 202 (1986) ("[A]t the summary judgment stage the judge's function is not himself to weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue for trial.").

We review *de novo* the district court's grant of summary judgment. *See, e.g., Kruso v. International Tel. & Tel. Corp.*, 872 F.2d 1416, 1421 (9th Cir.1989), *cert. denied*, 496 U.S. 937, 110 S.Ct. 3217, 110 L.Ed.2d 664 (1990). The evidence must be viewed in the light most favorable to the nonmoving party to determine whether there are any genuine issues of material fact for trial, and whether the district court correctly applied the relevant substantive law. *Gizoni v. Southwest Marine, Inc.*, 909 F.2d 385, 387 (9th Cir.1990), *aff'd*, — — U.S. ——, 112 S.Ct. 486, 116 L.Ed.2d 405 (1991).

III

The Duty of Care

O'Melveny must have violated a duty in order to be found negligent. The Firm concedes the existence of a duty by a principal and its agent of complete and accurate disclosure to potential investors in a securities offering, but argues that the investors here have all been fully compensated, and that the agent owes no additional duty to the successor in interest of a principal to make inquiries and disclose information which, the Firm argues, the principal already knew and was trying to conceal. In other words, O'Melveny contends that the federal agency created by Congress to rescue the economy and the victims of failing thrifts can claim no stronger ethical position than did the wrongdoers within that corporate entity; that the government agency is subject to all defenses that might lie as between the wrongdoers themselves and those who may have aided and abetted them in bringing about the disaster. We find such a proposition incredible, particularly when applied to the duties of attorneys retained to give advice and assistance with respect to public offerings.

Our starting point is the basic proposition that in general, "it is an attorney's duty to 'protect his client in every

possible way. . . .'" *Day v. Rosenthal*, 170 Cal.App.3d 1125, 1143, 217 Cal.Rptr. 89, 99 (1985) (citations omitted), *cert. denied*, 475 U.S. 1048, 106 S.Ct. 1267, 89 L.Ed.2d 576 (1986). Attorneys fulfill this duty by performing the legal services for which they have been engaged with "such skill, prudence and diligence as lawyers of ordinary skill and capacity commonly possess. . . ." *Id., quoting Lucas v. Hamm*, 56 Cal.2d 583, 591, 15 Cal.Rptr. 821, 825, 364 P.2d 685, 689 (1961), *cert. denied*, 368 U.S. 987, 82 S.Ct. 603, 7 L.Ed.2d 525 (1962).[4]

Furthermore, if an attorney "specializes within the profession, he must meet the standards of knowledge and skill of such specialists." *Neel v. Magana, Olney, Levy, Cathcart & Gelfand*, 6 Cal.3d 176, 188, 98 Cal.Rptr. 837, 844, 491 P.2d 421, 428 (1971). An attorney's failure to perform in accordance with his duty is negligence, because "[e]ven as to doubtful matters, an attorney is expected to perform sufficient research. . . ." *Smith v. Lewis*, 13 Cal.3d 349, 360, 118 Cal.Rptr. 621, 628, 530 P.2d 589, 596 (1975), *overruled on other grounds, In re Marriage of Brown*, 15 Cal.3d 838, 126 Cal.Rptr. 633, 544 P.2d 561 (1976); *Day v. Rosenthal*, 170 Cal.App.3d at 1146-47, 217 Cal.Rptr. 89.

O'Melveny's position is that a lawyer owes no duty to uncover a client's fraud nor to advise the client and the world of that fraud. The Firm points out that Cali-

[4] *See also* California Supreme Court, *Rules of Professional Conduct* (1989), *reprinted in Selected Standards on Professional Responsibility* (D. Morgan & R. Rotunda, eds. 1991): "To perform legal services competently means diligently to apply the learning and skill necessary to perform the [attorney's] duties arising from employment or representation." *Id.* at 246. While professional standards are not meant to give rise to civil liability, we find that "[t]he attempt to deny that there is anything in these codes of conduct that is relevant to the legal duty owed by a lawyer to his client is simply breathtaking. It is also quite wrong." A. Kaufman, *Problems in Professional Responsibility* 662 (3d ed. 1989).

fornia has recently reiterated its traditionally narrow construction of attorney malpractice exposure under California law. *See Kimmel v. Goland,* 51 Cal.3d 202, 213-14 n. 10, 271 Cal.Rptr. 191, 198 n. 10, 793 P.2d 524, 531 n. 10 (1990); *Skarbrevik v. Cohen, England & Whitfield,* 231 Cal.App.3d 692, 701-707, 282 Cal.Rptr. 627, 633-37 (1991). There are two problems with O'Melveny's approach. The first is the implication that if the client happens to be committing a fraud, of which the attorney may or may not be aware, the presence of the fraud cancels the attorney's duty to use due care. No California cases advise us of an exception to the general rule that a lawyer has to act competently to avoid public harm when he learns that his is a dishonest client. The *Skarbrevik* and *Kimmel* cases merely decline to expand this duty of attorneys; they do not create any exceptions to it.

The second problem with O'Melveny's approach is its sharp differentiation between a "duty to investors," which it concedes, and a "duty to the client," which it denies. Given a broad duty to protect the client, this distinction is a false one. Part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors. An important duty of securities counsel is to make a "reasonable, independent investigation to detect and correct false or misleading materials." *Felts v. National Account Sys. Assoc., Inc.,* 469 F.Supp. 54, 67 (N.D.Miss.1978). This is what is meant by a due diligence investigation. *Koehler v. Pulvers,* 614 F.Supp. 829, 845 (S.D.Cal.1985) (due diligence required lawyer's independent investigation of information supplied by issuer for incorporation into offering materials). The Firm had a duty to guide the thrift as to its obligations and to protect it against liability. In its high specialty field, O'Melveny owed a duty of due care not only to the investors, but also to its client, ADSB.

O'Melveny asserts that the Firm's attorneys "were deeply concerned with the proper portrayal of ADSB in the Gateway Center and Wells Park PPMs." FDIC's expert witness, Alan Berkeley, testified that in the circumstances of this case, fundamental due care required O'Melveny to contact Arthur Young, Touche Ross, and Rogers & Wells prior to signing and releasing the PPMs. The reasons for O'Melveny's lack of success in designing an accurate offering document constitute a triable issue of fact. Were a subsequent trier of fact to determine that O'Melveny had indeed been negligent, the Firm's negligence would not be based upon its declination to "ferret out fraud", but rather because it failed to make a reasonable, independent investigation. As one commentator has explained:

> [A]ttorneys, in rendering opinions relating to the securities laws, are not justified in assuming facts as represented to them by the client and in basing their opinion on the assumption that such facts are correct. Rather . . . the attorney must make a reasonable effort to independently verify the facts on which the opinion is based.

H. Bloomenthal, *Securities Law Handbook,* § 27.02 at 1096 (1990-91 ed.).

IV

Estoppel

Given a basic duty to give proper advice to the client who is asking the public to invest in its offerings, the next inquiry is whether the attorneys are absolved of that duty if there were wrongdoing officers inside the corporation. O'Melveny argues that the acts of the wrongdoing officers are attributable to the corporation itself, and because FDIC "stands in the shoes" of the corporation as its receiver, by transference, FDIC is entitled to no more than the wrongdoing officers themselves would have been. Under this argument, FDIC would be estopped

from making a claim against O'Melveny by the wrongdoing of the corporate insiders. We disagree with this flat statement of the law, particularly in view of the public expectation that the wrongdoing will be exposed, the wrongdoers pursued, and the innocent victims of fraud will have a chance at recovering.

A

The Thrift's Corporate Identity

O'Melveny bases its position on the unexceptionable general principle that the perpetrator of a fraud cannot be a victim of that fraud. ADSB has no identity separate from that of Sahni and Day, argues O'Melveny, and Sahni and Day as wrongdoers could not have been victimized by O'Melveny's supposed negligence. O'Melveny asserts that "even if it were careless," FDIC cannot pursue a claim against O'Melveny because FDIC stands in the shoes of the wrongdoers at ADSB, and FDIC's claims for relief are "barred by the plaintiff's unclean hands."

We thus begin this section of our inquiry with the issue of ADSB's corporate identity. Could this case, as O'Melveny has urged, have just as appropriately been entitled "Sahni and Day v. O'Melveny & Meyers"?

ADSB was the client here, not Sahni and Day. The misconduct of ADSB insiders provides O'Melveny with a defense only if the insiders' knowledge could be attributed to ADSB. Because these wrongdoers were acting adversely to ADSB and not on its behalf, principles of corporate identity and agency law preclude attribution, starting with the basic distinction between a corporation and its stockholders. "It is fundamental, of course, that a 'corporation is a distinct legal entity separate from its stockholders and from its officers.'" *Merco Constr. Eng'rs v. Municipal Court,* 21 Cal.3d 724, 729, 147 Cal.Rptr. 631, 634, 581 P.2d 636, 639 (1978) (citations omitted). This rule applies even when, as here, a single individual

owns nearly all of the corporation's stock. *In re John Koke Co.,* 38 F.2d 232, 233 (9th Cir.1930) *cert. denied sub nom. A.R. Demory Invest. Co. v. Haese,* 282 U.S. 840, 51 S.Ct. 21, 75 L.Ed. 746 (1930); *Potts v. First City Bank,* 7 Cal.App.3d 341, 345-46, 86 Cal.Rptr. 552, 555 (1970).[5]

We next inquire whether Sahni and Day's wrongdoing as corporate *officers* can appropriately be attributed to ADSB.[6] "Generally the knowledge of a corporate officer within the scope of his employment is the knowledge of the corporation. . . . [, however,] the knowledge acquired by the agent who is acting adversely to his principal will not be attributed to the principal." *Meyer v. Glenmoor Homes, Inc.,* 246 Cal.App.2d 242, 264, 54 Cal. Rptr. 786, 800-801 (1967) (citations omitted); *see also In re Investors Funding Corp.,* 523 F.Supp. 533, 540-41 (S.D.N.Y.1980) (holding that the misconduct of officers is not attributable to the corporation); *Holland v. Arthur Andersen & Co.,* 127 Ill.App.3d 854, 862-68, 82 Ill.Dec. 885, 890-94, 469 N.E.2d 419, 424-28 (1984) (sustaining an insurance company's malpractice claim against a debtor company's auditors, the court held that there could be no attribution of the knowledge of the debtor company's wrongdoers to the corporation because the wrongdoers were acting against the interests of the corporation).

The cases of *Schacht v. Brown,* 711 F.2d 1343 (7th Cir.1983), *cert. denied,* 464 U.S. 1002, 104 S.Ct. 509, 78 L.Ed.2d 698 (1983); *Cenco, Inc. v. Seidman & Seidman,* 686 F.2d 449 (7th Cir.1982), *cert. denied,* 459 U.S. 880, 103 S.Ct. 177, 74 L.Ed.2d 145 (1982); and

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[5] *Meehan v. Hopps,* 144 Cal.App.2d 284, 301 P.2d 10 (1956) is not to the contrary. That case actually held that corporate counsel do not have an attorney-client relationship with the corporation's shareholders. *See id.* at 293, 301 P.2d at 15. Subsequent California cases follow the holding in *Meehan. See, e.g., Ward v. Superior Court,* 70 Cal.App.3d 23, 32-33, 138 Cal.Rptr. 532, 537 (1977).

[6] Sahni and Day played two roles in relation to the corporation: as shareholders and as directors.

Investors Funding all turn on whether a corporate plaintiff (or, as here, its receiver) is estopped from recovering for the defendant's breach of duty because of the fraud of insiders. The holdings in *Schacht* (followed by this Circuit in *Kempe v. Monitor Intermediaries, Inc.*, 785 F.2d 1443, 1444 (9th Cir.1986)), *Cenco* and *Investors Funding* determine that there can be no attribution, and therefore no estoppel, when the insiders, rather than the corporation, benefit from the wrongdoing. *Schacht* at 1348; *Cenco* at 454-56; *Investors Funding* at 541.

Here, disaster, not benefit, accrued to ADSB through the malfeasance of Sahni, Day and Pope. *Schacht* and *Investors Funding* elaborate that conduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit that corporation. Indeed, under *Schacht,* even if the corporation were somehow to benefit from the wrongdoing of insiders, the insiders' conduct is still not attributable to the corporation if a recovery by the plaintiff would serve the objectives of tort liability by properly compensating the victims of the wrongdoing and deterring future wrongdoing. 711 F.2d at 1348; *accord, Cenco,* 686 F.2d at 455; *see also Lincoln Sav. & Loan Ass'n v. Wall,* 743 F.Supp. 901 (D.D.C.1990); *Diamond Mortgage Corp. v. Sugar,* 913 F.2d 1233, 1247-48 (7th Cir.1990) (applying *Investors Funding* to legal malpractice claims of corporations in bankruptcy against their pre-bankruptcy attorneys), *cert. denied,* —— U.S. ——, 111 S.Ct. 968, 112 L.Ed.2d 1054 (1991).[7]

Furthermore, we note that O'Melveny cannot invoke an estoppel defense unless it is innocent itself. *See, e.g., Meyers v. Moody,* 693 F.2d 1196, 1208 (5th Cir.1982) ("A party may not invoke an estoppel for the purpose of

[7] *Blain v. Doctor's Company,* 222 Cal.App.3d 1048, 1062, 272 Cal.Rptr. 250 (1990) is not to the contrary. There, a client was held to have "no cause of action for injury caused by his own misconduct," *id.* at 1062, 272 Cal.Rptr. at 258, whereas in the present case, we determine that attribution of the insider's wrongdoing to FDIC is inappropriate.

shielding himself from the results of his own fraud, dereliction of duty, or other inequitable conduct."), *cert. denied,* 464 U.S. 920, 104 S.Ct. 287, 78 L.Ed.2d 264 (1983).[8] We conclude that ADSB has a corporate identity distinct from that of its wrongdoing officers.

B

Role and Rights of FDIC

Even assuming Sahni and Day's knowledge would be imputed to ADSB so that ADSB would be estopped from bringing this lawsuit, this does not answer the question whether FDIC as receiver is estopped; there remains the problem of asserting against ADSB's successor an equitable defense that is good against ADSB. O'Melveny argues that under well-established California law, "[a] receiver occupies no better position than that which was occupied by the . . . party for whom he acts . . . and any defense good against the original party is good against the receiver." *Allen v. Ramsay,* 179 Cal.App.2d 843, 854, 4 Cal. Rptr. 575 (1960). Thus, if O'Melveny can raise an equitable estoppel defense against ADSB, it can raise it against receiver FDIC as well.

The flaw in this argument is the law O'Melveny assumes applies. It is by now clear beyond doubt that federal, not state, law governs the application of defenses against FDIC.[9] While we may incorporate state law to

[8] We are unpersuaded by O'Melveny's contrary citation to *McKenney v. Ellsworth,* 165 Cal. 326, 132 P. 75 (1913). The exception from *McKenney* does not apply because O'Melveny is not an innocent third party in this case. Cases where innocent victims of an agent's wrongdoing sue the principal are inapposite in this context. *See, e.g., Warshauer v. Bauer Constr. Co.,* 179 Cal.App.2d 44, 3 Cal.Rptr. 570 (1960); *Maron v. Swig,* 115 Cal.App.2d 87, 251 P.2d 770 (1952).

[9] *See D'Oench, Duhme & Co. v. FDIC,* 315 U.S. 447, 456, 62 S.Ct. 676, 679, 86 L.Ed. 956 (1942); *FDIC v. Bank of San Francisco,* 817 F.2d 1395, 1398 (9th Cir.1987); *see also FDIC v. Mmahat,*

provide the federal rule of decision, we are not bound to do so. *See FDIC v. New Hampshire Ins. Co.*, 953 F.2d 478, 481 (9th Cir.1991), *amended*, 953 F.2d 478 (9th Cir.1992). Thus, contrary to O'Melveny's argument, we are not bound by state law, but must instead establish federal law.

In fashioning a federal rule of decision, we are guided by the age-old principles that equity does equity, *see Van Rensselaer v. Kearney*, 52 U.S. (11 How.) 297, 325, 13 L.Ed. 703 (1850), and that "[e]quity will look through the form of the transaction, and adjust the equities of the parties with a view to its substance, ..." *Drexel v. Berney*, 122 U.S. 241, 254, 7 S.Ct. 1200, 1205, 30 L.Ed. 1219 (1887) (internal quotations omitted). These principles lead us to conclude that equitable defenses good against a bank do not carry over against the bank's receiver.

A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It was neither a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects or force the bank to pay for incurable defects. This places the receiver in stark contrast to the normal successor in interest who voluntarily purchases a bank or its assets and can adjust the purchase price for the diminished value of the bank's assets due to their associated equitable defenses. In such cases, the bank receives less consideration for its assets because of its inequitable conduct, thus bearing the cost of its own wrong.

Also significant is the fact that the receiver becomes the bank's successor as part of an intricate regulatory scheme designed to protect the interests of third parties

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907 F.2d 546, 550 (5th Cir.1990), *cert. denied*, —— U.S. ——, 111 S.Ct. 1387, 113 L.Ed.2d 444 (1991); *FDIC v. Gulf Life Ins. Co.*, 737 F.2d 1513, 1517 (11th Cir.1984).

who also were not privy to the bank's inequitable conduct. That scheme would be frustrated by imputing the bank's inequitable conduct to the receiver, thereby diminishing the value of the asset pool held by the receiver and limiting the receiver's discretion in disposing of the assets. *See Gulf Life*, 737 F.2d at 1517; *cf. Langley v. FDIC*, 484 U.S. 86, 91-92, 108 S.Ct. 396, 401-02, 98 L.Ed.2d 340 (1987).

In light of these considerations, we conclude that the equities between a party asserting an equitable defense and a bank are at such variance with the equities between the party and a receiver of the bank that equitable defenses good against the bank should not be available against the receiver. To hold otherwise would be to elevate form over substance—something courts sitting in equity traditionally will not do. *See Drexel*, 122 U.S. at 254, 7 S.Ct. at 1205. Of course, it does not necessarily follow that equitable defenses can never be asserted against FDIC acting as a receiver; we hold only that the bank's inequitable conduct is not imputed to FDIC.

V

The Measure of Damages

If FDIC is successful in this case, the appropriate measure of damages would be the out of pocket costs to the client properly attributable to the fraudulent transaction. This would include a denial of O'Melveny's cross-claim for its fees, rescission of any fees paid to O'Melveny, settlement costs, brokers' commissions, and any losses on property purchased as a result of the offerings having closed, provided such losses can be documented with the requisite level of certainty at trial. FDIC is not seeking reimbursement for the rescission payments to the investors, which were underwritten by a subsidiary of ADSB.

VI

Conclusion

We hold that O'Melveny owed a duty of care to its client ADSB and that there are genuine disputes of material fact as to whether that duty was discharged. The case is yet to be tried; we do not assume how the dispute will eventually be resolved, but we find there to be issues for trial. We also hold that FDIC, acting as an involuntary successor in interest pursuant to a federal regulatory scheme, is not estopped from litigating its claims against O'Melveny because of the "unclean hands" of the ADSB insiders. The judgment of the district court which held as a matter of law that no issues of material fact could be proved because FDIC has no standing is erroneous and therefore that judgment is hereby REVERSED and REMANDED for further proceedings consistent with this opinion.

APPENDIX B

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

Case No. CV 89-2877 TJH (Kx)

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, as Receiver for AMERICAN DIVERSIFIED SAVINGS BANK, *et al.*,

Plaintiffs,

vs.

O'MELVENY & MYERS, a law partnership,

Defendant.

O'MELVENY & MYERS, a law partnership,

Counterclaimant,

vs.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, as Receiver for AMERICAN DIVERSIFIED SAVINGS BANK and ADC FINANCIAL CORPORATION,

Counterdefendants.

LOS ANGELES, CALIFORNIA

MONDAY, APRIL 9, 1990, 10:00 A.M.

THE COURT CLERK: Item No. 5, Civil Action, CV 89-02877-TJH, FDIC, etc., versus O'Melveny & Myers.

Counsel, make your appearances, please.

MR. SMITH: Good morning, Your Honor.

Gregory Smith and Sarah Lipscomb with the law firm of Irell and Manella, representing the defendant and moving party O'Melveny & Myers.

THE COURT: Thank you, both.

MR. RUSSELL: Good morning, your honor.

Theodore Russell and Sharon O'Grady of Pettit and Martin for the plaintiff Federal Deposit Insurance Corporation.

THE COURT: Thank you.

Does anyone have something to add to their papers that were inadvertently left out?

MR. SMITH: Your Honor, that is always a hard question.

THE COURT: Not really.

Did you leave something out of your papers?

MR. SMITH: No, Your Honor. I don't think we did leave anything out of our papers.

I think the key issue here is a very clear one.

And that is whether the knowledge of Messrs. Sauny and Day (Phonetic) are to be imputed to the corporation, And I think on that issue we have made our position very clear, and that that takes care of the entire question of whether ADSB has a cause of action against O'Melveny and Myers.

On the second major portion of the case, which is the cause of action of the investors, I again think our papers are quite clear that no such claim can any longer be presented.

THE COURT: All right.

Does Any one else wish to be heard?

MR. RUSSELL: We have nothing to add to our papers, Your Honor.

THE COURT: All right.

Well, I think it is fairly clear that the purpose of the Securities Act is to compel full and fair disclosure but two of the investors, and knowing that the investors have

been protected here since, indeed, there has been the repayment, we no longer have a problem as far as O'Melveny is concerned.

They owe no duty to any one other, so I am going to grant their motion for summary judgment.

We will need an order.

Will you prepare that order, then, Mr. Smith?

MR. SMITH: Yes, I will, Your Honor.

Thank you, very much.

THE COURT: All right.

Thank you.

(The proceedings were concluded.)

APPENDIX C

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

Case No. CV 89-2877 TJH (Kx)

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, as Receiver for AMERICAN DIVERSIFIED SAVINGS BANK, *et al.*,
Plaintiffs,

vs.

O'MELVENY & MYERS, a law partnership,
Defendant.

O'MELVENY & MYERS, a law partnership,
Counterclaimant,

vs.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, as Receiver for AMERICAN DIVERSIFIED SAVINGS BANK and ADC FINANCIAL CORPORATION,
Counterdefendants.

[PROPOSED]
ORDER GRANTING
SUMMARY JUDGMENT

[Filed May 15, 1990]

ORDER

The motion of defendant O'Melveny & Myers ("O'Melveny") for Summary Judgment in its favor on the Complaint herein came on regularly for hearing on April 9,

1990, before The Honorable Terry J. Hatter, Judge of the United States District Court. Theodore Russell and Sharon O'Grady of Pettit & Martin appeared as attorneys for the plaintiffs, and Gregory R. Smith and Sara D. Lipscomb of Irell & Manella appeared as attorneys for defendant.

After full consideration of the evidence and points and authorities submitted by the parties, and after the opportunity of oral argument, the Court finds that O'Melveny has shown by admissible evidence and reasonable inferences therefrom, not controverted by other evidence or inferences, that none of the causes of action in the Complaint has merit, that there is no genuine dispute or triable issue as to any material fact, that O'Melveny is entitled to judgment in its favor with respect to the Complaint as a matter of law, and that there is no just reason for delay with respect to entry of judgment. Accordingly,

IT IS ORDERED that O'Melveny's Motion for Summary Judgment be, and hereby is, granted in favor of O'Melveny and against plaintiffs, that the Complaint against O'Melveny is accordingly dismissed with prejudice, that pursuant to Rule 54(d) of the Federal Rules of Civil Procedure judgment should be entered at this time, and that defendant is entitled to costs herein.

DATED: May 15, 1990.

/s/ Terry J. Hatter, Jr.
TERRY J. HATTER
United States District Judge

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 90-55769

D.C. No. CV-89-2877-TJH

FEDERAL DEPOSIT INSURANCE CORPORATION, as Receiver; AMERICAN DIVERSIFIED SAVINGS BANK; ADC FINANCIAL CORP.; AMERICAN DIVERSIFIED WELLS PARK II, *et al.*,
Plaintiffs-Appellants,

v.

O'MELVENY & MYERS,
Defendants-Appellees.

ORDER

[Filed June 30, 1993]

Before: POOLE, KOZINSKI and LEAVY, Circuit Judges.

The panel has voted to deny the petition for rehearing and to reject the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

(2)

No. 93-489

In the Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS, PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION
AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS
BANK, ET AL.

*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT*

BRIEF FOR THE FEDERAL DEPOSIT INSURANCE CORPORATION

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QUESTION PRESENTED

The Federal Savings and Loan Insurance Corporation, acting as receiver for a failed federally insured savings institution, brought suit against a law firm for giving negligent legal advice to the institution before its insolvency. The law firm seeks to defend the suit on the ground that the savings institution itself would be barred from suit because the conduct of its wrongdoing officers (who retained the law firm) would be imputed to it. The question presented is whether this wrongdoing is also to be imputed to the receiver so as to bar it from pursuing claims against the law firm for damage caused to the bank's financial condition by the firm's professional malpractice.

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*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT*

BRIEF FOR THE FEDERAL DEPOSIT INSURANCE CORPORATION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-16a) is reported at 969 F.2d 744. The opinion of the district court (Pet. App. 17a-19a) is not reported.

JURISDICTION

The judgment of the court of appeals was entered on June 29, 1992. A petition for rehearing was denied on June 30, 1993. Pet. App. 22a. The petition for a writ of certiorari was filed on September 27, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. This case arises out of the failure of American Diversified Savings Bank (ADSB), a federally insured financial institution; petitioner provided legal services to that institution before it failed. On February 14, 1986, the Federal Savings and Loan Insurance Corporation (FSLIC) became conservator for ADSB. Five days later it filed a lawsuit in federal court alleging that Ranbir Sahni and Lester Day (the Chief Executive Officer and President, respectively, of ADSB) had breached fiduciary duties to the institution in connection with two securities offerings, and that Day's conduct amounted to racketeering violations. Subsequently, the offerings were rescinded and the investors were repaid the sums they had invested. On May 12, 1989, FSLIC filed this suit against petitioner, charging that petitioner's representation of the institution in connection with the offerings had been negligent and involved a breach of fiduciary duty; FSLIC sought to recover from petitioner the funds the institution lost as a result of the rescinded offerings. See Pet. App. 1a-5a; Pet. 3.

2. The district court granted summary judgment in favor of petitioner and against the Federal Deposit Insurance Corporation (FDIC),[1] apparently reasoning that petitioner's only duty was to the investors, and that the repayment of the investors absolved petitioner of further liability. Pet. App. 17a-19a.

3. The court of appeals reversed. Pet. App. 1a-16a. The court first rejected the district court's under-

[1] FSLIC became receiver in 1988. The FDIC succeeded FSLIC as receiver by operation of law on August 10, 1989. 12 U.S.C. 1821a(a)(5)(A) (Supp. IV 1992).

standing of petitioner's duty of care, *id.* at 6a-9a, stating that an attorney under California law has a duty "to protect the client from the liability which may flow from promulgating a false or misleading offering to investors," *id.* at 8a. In the court's view, the FDIC's allegations raised a question of fact regarding petitioner's compliance with that duty. *Id.* at 9a.

The court then considered petitioner's argument that the FDIC was estopped from bringing this action because insiders of the failed institution (Sahni and Day) were aware of the wrongdoing, and because their knowledge must be attributed to the institution and then, in turn, to the FDIC. Pet. App. 9a-15a. The court first concluded that the knowledge of the malfeasant officers should not be attributed to the institution "if a recovery by the plaintiff would serve the objectives of tort liability by properly compensating the victims of the wrongdoing and deterring future wrongdoing." *Id.* at 12a.[2] The court then held, in the alternative, that even if the knowledge of the malfeasant officers were to be attributed to the institution, that knowledge would as a matter of federal law not estop the FDIC as receiver. *Id.* at 13a-15a. The court noted that the FDIC "was neither

[2] The court of appeals did not analyze the choice-of-law question on this issue. The primary authorities on which it relied in this portion of its opinion, however, were based on federal law and the law of States other than California. See Pet. App. 11a-12a (citing *Schacht* v. *Brown*, 711 F.2d 1343 (7th Cir.), cert. denied, 464 U.S. 1002 (1983); *Cenco, Inc.* v. *Seidman & Seidman*, 686 F.2d 449 (7th Cir.), cert. denied, 459 U.S. 880 (1982); and *In re Investors Funding Corp.*, 523 F. Supp. 533 (S.D.N.Y. 1980)).

a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects." *Id.* at 14a. Hence, the court reasoned, "imputing the bank's inequitable conduct to the receiver" would "frustrate[]" the statutory scheme "[b]y diminishing the value of the asset pool held by the receiver and limiting the receiver's discretion in disposing of the assets." *Id.* at 15a.

ARGUMENT

For the reasons summarized in the petition we are filing today in *FDIC* v. *Shrader & York*, we believe that the decision of the court of appeals in this case is correct.[3] Under federal law, which governs defenses in cases brought by the FDIC as receiver for failed financial institutions, the wrongdoing of insiders is, as the Ninth Circuit has held, not to be attributed to the FDIC so as to bar its suits on behalf of creditors the institution, and the public.

We agree with petitioner, however, that the holding of the court of appeals here conflicts with the contrary law of the Fifth Circuit as established in the *Shrader & York* case and in *FDIC* v. *Ernst & Young*, 967 F.2d 166 (1992). Furthermore, the question is of profound importance to the FDIC. The FDIC manages the estates of literally hundreds of failed financial institutions, and in a substantial portion of those cases is pursuing claims that malfeasance by insiders—frequently aided by law firms and other third parties, as in this case and in *Shrader & York*—

[3] We have provided counsel for petitioner a copy of our petition in *Shrader & York*.

contributed to the failure of the institution. The sums of money at stake are enormous; the FDIC estimates that it is pursuing similar claims in amounts that exceed $1.5 billion. If the wrongdoing of insiders that takes place before insolvency is to be attributed to the FDIC when it subsequently becomes receiver, that effectively will bar recovery in these cases.

Hence, as we state in the petition in *Shrader & York*, we believe that it would be appropriate for the Court to grant the petition in this case in order promptly to resolve this important issue.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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OCTOBER 1993

No. 93-489

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS, A LAW PARTNERSHIP,
Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION,
AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK,
ADC FINANCIAL CORPORATION, AMERICAN
DIVERSIFIED/WELLS PARK II, AND AMERICAN
DIVERSIFIED/GATEWAY CENTER,
Respondents,

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

AMICUS CURIAE BRIEF OF BEUS, GILBERT & MORRILL, P.L.L.C. IN SUPPORT OF THE POSITION OF PETITIONER O'MELVENY & MYERS

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Pursuant to Rule 37 of the Rules of the Supreme Court of the United States, *amicus curiae* Beus, Gilbert & Morrill, P.L.L.C., ("BG&M") respectfully submits this brief in support of the Petition of O'Melveny & Myers ("O'Melveny") for Writ of Certiorari (the "Petition"). Petitioner and Respondents have both consented to BG&M's filing of this brief *amicus curiae.*

INTEREST OF *AMICUS CURIAE*

BG&M is a law firm engaged in the general practice of law in Phoenix, Arizona. From 1982 through 1989 BG&M performed certain discrete services for Western Savings & Loan Association ("Western"), an Arizona chartered, federally insured, association. Western was founded in 1929 by the Driggs family and provided housing finance in Arizona until it was taken over by FDIC on June 14, 1989. Western was the second largest Arizona savings and loan in 1989, with assets of over $5.0 billion. BG&M was not general counsel, securities counsel, or regulatory counsel for Western, and was never engaged to advise it on financial or accounting issues. BG&M had no lawyers who were on Western's board of directors or who otherwise participated in the management or business planning of Western. Instead, BG&M provided to Western, on request, legal services in the areas of foreclosures, zoning and land use planning, commercial litigation, and documentation of loan transactions.

On June 13, 1992 the Resolution Trust Corporation ("RTC") filed in the federal district court for the district of Arizona, its complaint styled *Resolution Trust Corporation v. Driggs, et. al.* Cause No. CIV 92-1080-PHX-EHC. In that action the RTC alleges that a "Control Group" of "racketeers" at Western caused it to engage in imprudent lending practices and improper accounting for sales of real estate. The RTC named BG&M as a defendant in that action, asserting that as transactional counsel engaged by Western to document loans previously underwritten and approved

by Western's in-house lending experts, BG&M had an obligation to perform its own financial underwriting of prospective borrowers, verify that appraisals Western obtained on collateral were sound, audit compliance by Western's loan officers, appraisers, and loan committees with prudent loan underwriting standards and regulatory recordkeeping requirements, and, in effect, determine at the time a transaction was being documented, that the "Control Group" would later improperly account for real estate sales. Had BG&M done so, RTC alleges, it would have prevented Western from entering into the transactions BG&M documented, which had been duly approved by Western's internal loan underwriting and approval process.

Because the duties alleged by RTC against BG&M do not exist under traditional state law principles of professional liability, RTC is apparently contending as did FDIC in this case, that some federal common law rules should be invented to create liability where none exists under state law and thereby "maximize the asset pool."

STATEMENT OF THE CASE

The FDIC filed this action as receiver for American Diversified Savings Bank ("ADSB"), a failed California savings and loan association, formerly represented by O'Melveny. It alleged legal malpractice and breach of fiduciary duty in connection with preparation of two offering memoranda for real estate securities offerings sponsored by ADSB affiliates. O'Melveny asserted that ADSB's 100% shareholders and principal officers and directors were well aware of the facts allegedly not disclosed in the offering memoranda, and actively concealed the information from O'Melveny. Therefore, O'Melveny contended, it did not owe a duty to discover and inform ADSB of that which it already knew and was concealing from O'Melveny. The district court granted summary judgment to O'Melveny. On appeal, the Court of Appeals for the Ninth Circuit reversed. *F.D.I.C. v. O'Melveny & Myers,* 969 F.2d 744 (9th Cir. 1992). The Ninth Circuit denied O'Melveny's Petition for Rehearing and Suggestion of Rehearing *en Banc.*

The Ninth Circuit acknowledges the motivation for its result by the emotional content of its paraphrase of O'Melveny's contention:

> that the federal agency created by Congress to rescue the economy and the victims of failing thrifts can claim no stronger ethical position than did the wrongdoers within the corporate entity. 969 F.2d at 748.

Draped in its ethical mantle, the Ninth Circuit concludes, without the analysis required by controlling cases in this Court, that "while we *may* incorporate state law to provide the federal rule of decision, we are not bound to do so." 969 F.2d at 751 (emphasis added). The Ninth Circuit then fashioned a rule of federal law justified only by its acknowledged desire to maximize the "asset pool." 969 F.2d at 752.

WHY THE PETITION SHOULD BE GRANTED

This case presents many reasons why the Court should exercise its discretion in granting O'Melveny's Petition. O'Melveny's Petition has set forth several: First, the conflict between the Ninth Circuit's decision below and the Fifth Circuit's decisions in *F.D.I.C. v. Ernst & Young,* 967 F.2d 166 (5th Cir. 1992), and *F.D.I.C. v. Schrader & York,* 991 F.2d 216 (5th Cir. 1993) should be resolved. Second, given the hundreds of pending cases involving billions of dollars of claimed damages and hundreds of millions of dollars per year in defense costs to professionals, the Court should take this early opportunity to resolve the conflict, rather than waiting for further development in the Circuit Courts of Appeal. There is however, an equally pressing and fundamental reason why the Court should grant the Petition, and it is this reason *amicus curiae* desires to highlight.

This Court is the pinnacle of the American legal profession, and must be the guardian of its central values. The

Ninth Circuit's decision strikes at one of the most fundamental principles of our profession – that lawyers' relationships with their clients should be judged by known standards, established by the states that regulate their conduct, which are in effect when the conduct in question occurs. The Ninth Circuit believes that federal judges should invent, after the fact, the standards by which lawyers' conduct should be retroactively judged, with the only guiding principle being that the chosen standards must maximize the recoveries of FDIC and RTC in litigation against lawyers. This Court should exercise its position of leadership to give a prompt burial to that pernicious notion.

Private practitioners engaged in a local practice are directly regulated by the highest court of their respective states in matters of licensure, continuing legal education, and discipline. To the extent lawyers in their practice depart from the standard of care in their local communities, they should be subject to potential liability based upon that community standard of care. But a California law firm, which from its California office advises a California client on a matter, should not later face, as if through Alice's looking glass, a claim that as a matter of California law its client simply could not assert against it. The subsequent seizure of the client's business by federal regulators (who had themselves approved applications to insure the bank's accounts as well as the identity of the bank's directors and senior management, and made periodic examinations of its operations) cannot "create" a claim the client itself could not have asserted.

Bluntly stated, the Ninth Circuit's result is an absurd, unfair, and untenable position, properly deserving of Mr. Bumble's epithet.[1] This Court should take the opportunity to correct this appalling, unprincipled injustice to O'Melveny and to the entire American legal profession.

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[1] C. Dickens, *Oliver Twist,* Ch. 51 (" 'If the law supposes that,' said Mr. Bumble, . . . 'the law is a ass – a idiot.' ").

SUMMARY OF ARGUMENT

This Court has consistently held that federal courts should presumptively look to state law for rules of decision, unless specific federal program objectives *require* adoption of a uniform federal rule. Only when the elements articulated in *United States v. Kimbell Foods,* 440 U.S. 715 (1975) are met should a federal court fashion a rule of federal common law to displace a well developed body of otherwise generally applicable state law. The Ninth Circuit applied federal law to reach its desired outcome, without undertaking the *Kimbell Foods* analysis. Under that analysis, federal courts should clearly look to state law as providing the rule of decision in this case.

This Court has also rejected the notion that the federal government's desire to "maximize the asset pool" is a sufficient basis for inventing federal common law to displace a well developed body of otherwise generally applicable state law. *United States v. Yazell,* 382 U.S. 341 (1966); *United States v. Kimbell Foods, supra.* The Ninth Circuit intentionally disregarded these precedents in its result-oriented opinion. Moreover, a review of the policy history of federal regulation of thrifts – as written by the federal government itself – compels the conclusion that Congress and the regulators identified as early as 1983 the risks that faced the industry in light of its weakened capital position and newly granted powers to invest in real estate assets, and intentionally allocated the risk of a systemic failure, such as occurred in 1988–90, to the "taxpayers" in general rather than to professionals serving the industry.

ARGUMENT

I. *EVEN WHERE FEDERAL LAW APPLIES, THERE IS A PRESUMPTION THAT STATE LAW SHOULD BE INCORPORATED INTO THE FEDERAL COMMON LAW AS THE RULE OF DECISION.*

Even where substantive federal law must be applied, it does not necessarily follow "that the content of such a rule must be wholly the product of a federal court's own devising." *Kamen v. Kemper Financial Services,* 500 U.S. , , 111 S. Ct. 1711, 1717, (1991). The Court viewed its prior cases as establishing:

> that a court should endeavor to fill the interstices of federal remedial schemes with uniform federal rules only when the scheme in question evidences a distinct need for nationwide legal standards . . . or when express provisions in analogous statutory schemes embody congressional policy choices readily applicable to the matter at hand. *Id.*

Except in those narrow circumstances,

> We have indicated that federal courts should "incorporat[e] [state law] as the federal rule of decision," unless "application of [the particular] state law [in question] would frustrate specific objectives of the federal programs." *Id.*

These rules create a "presumption that state law should be incorporated into federal common law." *Id.* This presumption is "particularly strong in areas in which private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state law standards." *Id.*

The Ninth Circuit's opinion does not identify any statutory provision that "evidences a distinct need for nationwide legal standards." Nor does it point to "express

provisions in analogous statutory schemes [that] embody congressional policy choices readily applicable to the matter at hand." The Financial Institution Reform, Recovery and Enforcement Act of 1989, P.L. No. 101-73, 103 Stat. 183 ("FIRREA") and its legislative history demonstrate that Congress intentionally stopped short of imposing uniform federal standards for the elements of and defenses to professional liability of a thrift's outside professionals.[2]

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[2] In 1989, Congress specifically addressed the issue of what additional powers the federal banking agencies needed with respect to outside professionals who provided services to insured depository institutions. Although Congress authorized the banking agencies acting in their governmental (as opposed to receivership) capacity to assert a new cause of action against outside professionals, it imposed liability only for knowing or reckless behavior, not for mere negligence, and thus the FDIC could not have maintained this negligence cause of action had it brought suit in its governmental capacity. 12 U.S.C. § 1818(b)(6)(A); 12 U.S.C. § 1813(u). In making this determination, Congress was aware of the complex policy considerations involved and acted only after hearing the views of all parties (H.R. Rep. No. 54(I) at 466):

> [FIRREA] places limitations on the banking agencies, so that they cannot utilize their enforcement authority over independent contractors for necessarily the same misconduct, abuse, or violations which can give rise to enforcement orders against officers, directors, and employees of financial institutions . . . [I]nclusion of these independent contractors has raised the concern of the American Institute of Certified Public Accountants, the American Bar Association's Business Law Section, and other groups. The Committee believes that section 9001 addresses these concerns. Accordingly, the Committee has limited the exposure of independent contractors to serious misconduct.

This fundamental policy determination of Congress will be undermined if the Ninth Circuit's decision is allowed to stand. The Ninth Circuit, motivated solely to protecting the FDIC's "asset pool," would allow the FDIC to recover in this case even though (1) the FDIC could not recover under the cause of action specifically created by Congress to protect the deposit insurance system after extended hearings and careful consideration, and (2) the failed institution itself could not have recovered under established principles of corporate and professional malpractice law. Whatever one's view of the merits of the Ninth Circuit's analysis, the judiciary clearly is not the proper forum for these decisions to be

Nor does the Ninth Circuit's opinion identify any "*specific* objectives of the federal programs" that would be "frustrated" by application of traditional state law rules. Instead, it concludes that the generalized federal policy of "maximizing the asset pool" requires creation of federal rules whose only rationale is that they make it easier for the FDIC to establish liability and/or damages in cases it has chosen to file.

Nor does the Ninth Circuit analyze the impact of creating a federal common law rule on the parties' expectations that their rights and obligations would be governed by state law. ADSB was a state chartered thrift with its operations in California. Its legal relationships with borrowers, depositors, and vendors, including professional service providers, were thus based on an expectation that California law would govern. O'Melveny is primarily centered in California, and would expect that its relations with ADSB (like all its other relationships with California based clients) would be governed by California law. The attorney/client relationship has historically been governed by state law which establishes standards of ethical conduct, as well as the elements of and defenses to professional liability claims, and is intensely regulated by the states. The FDIC has shown no basis for disregarding the "ready made body of state law" and thereby frustrating the expectation of the parties.

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made. *See FDIC V. Braemoor Assoc.*, 686 F.2d 550, 554 (7th Cir. 1982) *cert. denied*, 461 U.S. 927 (1983) ("the absence of any ready-made federal common law in most of the areas of law in which it might be applied, and a general reluctance to displace state law without explicit statutory or constitutional direction to do so, support a presumption that state law is adequate and should be adopted by the federal court as the rule of decision.").

II. *THE FDIC'S INTEREST IN "MAXIMIZING THE ASSET POOL" IS INSUFFICIENT TO OVERCOME THE PRESUMPTION THAT STATE LAW SHOULD BE INCORPORATED AS THE FEDERAL RULE OF DECISION.*

A. *Prior Cases Reject Protectionist Fiscal Policies as an Adequate Justification for Refusing to Incorporate State Law as the Federal Rule of Decision.*

This Court has twice held that "protectionist fiscal policies underlying" a federal program do not constitute the showing of frustration of "specific objectives of the federal programs" required to override the "presumption that state law should be incorporated into federal common law."

In *United States v. Yazell*, 382 U.S. 341 (1966), the Government argued that maximizing recovery on SBA guaranteed loans required that federally insured SBA loan contracts prevail over state coverture rules. The Court properly observed that

> every creditor has the same interest in this respect; every creditor wants to collect. The United States, as sovereign, has certain preferences and priorities, but neither Congress nor this Court has ever asserted that they are absolute. 382 U.S. 348-49.

The Court rejected SBA's "generalized pleas for uniformity as substitutes for concrete evidence that adopting state law would adversely affect administration of the federal programs." *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 730 (1975).

Similarly, in *United States v. Kimbell Foods, Inc., supra*, SBA and FHA urged the Court to adopt federal common law lien priority rules to give the agencies priority over liens that were "inchoate" at the time the federally insured extension of credit occurred. Again, the interest advanced was that minimizing losses to the Government

required adoption of uniform federal rules. The Court rightfully described this interest as "protectionist fiscal policies underlying the programs." Such an interest is not the kind of "specific objectives of the federal programs" which must be frustrated by non-discriminatory state law in order to avoid the presumption of incorporating state law as the federal rule of decision. The Court held:

> We are unpersuaded that in the circumstances presented here, nationwide standards [favoring claims of the United States] are necessary to ease program administration or to safeguard the federal treasury from defaulting debtors. Because the state commercial codes 'furnish convenient solutions in no way inconsistent with adequate protection of the federal interest[s],' . . . we decline to override intricate state laws of general applicability on which private creditors based their daily commercial transactions.

The Court held that those "generalized pleas for uniformity" are not a substitute for "concrete evidence that adopting state law would adversely affect administration of the federal programs." *United States v. Kimbell Foods, Inc., supra,* 440 U.S. at 729–730.

The Court further examined the Government's assertion that "applying state law to these lending programs would undermine its ability to recover funds disbursed and therefore would conflict with program objectives." 440 U.S. at 733. The Government argued that it is impossible to distinguish between "a dollar received from the collection of taxes and a dollar returned to the treasury on repayment of a federal loan," so the fiscal interest which led to the "choateness doctrine" in the federal tax lien context justifies bringing those rules also into the federal lending programs. The Court described SBA and FHA programs as "a form of social welfare legislation, primarily designed to assist farmers and businesses that cannot obtain funds from private

lenders on reasonable terms." 440 U.S. at 735. The Court then concluded:

> We believe that had Congress intended the private commercial sector, rather than taxpayers in general, to bear the risks of default entailed by these public welfare programs, it would have established a priority scheme displacing state law. Far from doing so, both Congress and the agencies have expressly recognized the priority of certain private liens over the agency's security interests, thereby indicating that the extraordinary safeguards supplied in the tax lien area are unnecessary to maintaining the lending programs. *Id.*

Finally, the Court noted that businessmen "depend on state commercial law to provide the stability essential for reliable evaluation of the risks involved," and that creating special rules for federal contractual liens "could undermine that stability." 440 U.S. at 739-40. Creditors who "justifiably rely on state law to obtain superior liens would have their expectations thwarted whenever a federal contractual security interest suddenly appeared and took precedence." *Id.* Since the Government was unable to advance any "concrete reasons [as opposed to 'protectionist fiscal policies' underlying the program] for rejecting well established commercial rules which have proven workable over time," the Court took the "prudent course" of adopting "the ready made body of state law as the federal rule of decision until Congress strikes a different accommodation." 440 U.S. at 740.

In this case, as in *Kimbell Foods, Inc.* and *Yazell,* the Ninth Circuit's justification for a uniform federal rule favoring the FDIC is only the generalized interest in maximizing the asset pool. As in *Yazell* and *Kimbell Foods, Inc.,* these generalized assertions are not a substitute for a showing of "specific program objectives" that would be frustrated by

applying non-discriminatory state law establishing the elements of and defenses to a professional liability claim. Congress had the opportunity "to strike a different accommodation" when it enacted FIRREA, but made a clear choice not to do so.[3]

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[3] *See* Note 2, *supra*. The Ninth Circuit also seems to justify its federal common law rule with the observation that "a receiver . . . does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It was neither a party to the inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects or force the bank to pay for incurable defects." 969 F.2d at 751-52. The Ninth Circuit ignores completely the fact that the FSLIC was not obligated to insure the deposit accounts of all state chartered savings and loan associations. 12 U.S.C. § 1726(a)(2). It insured only those who applied for insurance and met the requirements imposed by FSLIC. 12 U.S.C. § 1726(b). One of the key requirements for insurance of accounts is a regulatory finding of satisfactory management. The statute provides that FSLIC "*shall* reject the application of any applicant if it finds that the applicant is impaired or that its financial policies or management are unsafe; and may reject the application of any applicant if it finds that the character of the management or its home financing policy is . . . inconsistent with the purpose of this chapter." *Id*. Under the applicable statutes, the FHLBB had the power to examine the institution periodically, to issue cease and desist orders, and to take other appropriate regulatory action including supervisory agreements requiring advance regulatory approval of significant transactions, and withdrawal of insurance of accounts, if an institution was not being operated in a safe and sound manner, or if its regulatory capital was impaired or threatened, or if it were violating any applicable law, rule or regulation. 12 U.S.C. § 1730(b). It also had the power to suspend or remove directors or officers who violate statutes, rules or regulations or engage in unsafe and unsound practices. 12 U.S.C. 1730(g). FHLBB had the power to examine the affairs of an insured institution and take supervisory action based thereon. 12 U.S.C. §§ 1726(b), 1730(m)(1)–(3). "FHLB examiners were investigating ADSB for two years prior to the takeover. The regulators were closely overseeing the thrift and had the ability, either independently or through FSLIC, to uncover the facts and notify ADSB of the discovery." *California Union Ins. v. American Diversified Savings Bank*, 948 F.2d 556, 565 (9th Cir. 1991). Thus, federal regulatory authorities had a great deal of information concerning and control over ADSB before becoming its receiver.

B. *Congress Increased the Risks to the FSLIC Fund, Failed to Enact Recommended Reforms, and Expressly Allocated the Risk of Systemic Failures to Society as a Whole.*

The FDIC's "asset pool argument" expressly invokes the Court's sympathy for the plight of the "taxpayers" who bear the cost of the "bailout" granted by Congress to the depositors of failed thrifts. To the extent such policy judgments are the province of the judiciary at all, a brief review of the policy history demonstrates that such pleas for sympathy are unfounded. Congress enacted laws which dramatically increased the risk to the FSLIC fund and then failed to enact reforms to address the resulting "instability," which the Federal Home Loan Bank Board ("FHLBB") identified in writing to Congress. Moreover, the FSLIC fund was never meant to be large enough to handle systemic failures; federal policy was to spread the cost of systemic failures "across society" using "general revenues of the Government."

Since 1987, one-third of savings and loans nationwide have failed, concentrated in Texas, Louisiana, Florida, and the Southwest. These failures accompanied regional real estate depressions and consequent precipitous declines in the value of real estate owned by, or securing loans held by, thrifts. That such large numbers of the nation's thrifts have failed since 1988, clearly indicates systemic or macroeconomic failures.

As early as 1983, the FHLBB, in a congressionally mandated report to Congress, warned that the decimation of the thrift industry by the high interest rates and negative yield curve of the early 1980's, coupled with partial deregulation of the industry accomplished by congressional and regulatory action between 1979 and 1982, created a clear danger of industry-wide, systemic failures.[4] In the introductory section, the FHLBB states the problem and sounds the ominous warning:

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[4] FHLBB, *Agenda For Reform, A Report to the Congress From the*

> Federal deposit insurance was created during the Great Depression as a way of restoring public confidence in the U.S. Financial system. Indeed, the legislation of that time developed and installed a new financial structure for the nation. As stability gradually returned, banks and thrift institutions regained their health and grew at a measured pace under close government regulation.
>
> More recently, however, conditions in financial markets have become increasingly volatile. Additional pressures on regulated depository institutions have resulted from the innovations of unregulated firms and investors. Deregulation has occurred in many sectors of the economy, with substantial changes taking place in the financial services industry.
>
> Partial deregulation, however, has created its own problems. Deposit insurance was designed for one regulatory structure, but a very different one is now developing. **The current system is unstable; without reform, it threatens the viability of federal deposit insurance.** *Agenda for Reform* at 10 (emphasis added).

The report noted that recent legislative changes had "lowered the barriers that have segmented commercial banks from S&Ls" and "relaxed the constraints that were imposed on managers of S&Ls regarding the composition of both the asset and liability sides of their balance sheets." As a result, "there is now a much greater opportunity for

Federal Home Loan Bank Board (U.S. Government Printing Office, Washington, D.C. 1983) (hereinafter "*Agenda for Reform*"). The FHLBB notes that *Agenda for Reform* was prepared "with the invaluable help of a Drafting Committee of distinguished scholars, commentators who represented a broad range of professional experts, and the Bank Board Staff." *Agenda for Reform* at iii-v, 2, and Appendix D.

managerial capabilities to be reflected in performance." FHLBB observed that "these changes do not guarantee the savings and loan industry a bright future," but only permit and require the industry to compete with other financial service companies; and warned that "those that are not prepared to compete in the next decade will not survive." *Id.* at 39.

The FHLBB noted that this competition presents FSLIC with "a new set of problems," requiring that FSLIC

> protect itself as well as the depositors in insured institutions by seeking to control risk taking by managers of insured institutions without the kind of direct regulatory constraints that have been available in the past. *Id.* at 40.

The FHLBB explained that "financial institutions were originally regulated" to control "the risk associated with depository institutions' actions." In the future,

> insurance agencies must limit risk through regulations that constrain the activities of insured institutions or through pricing mechanisms that provide proper incentives for risk-taking. **If neither option is available, then the insurance agency is exposed to considerable risk.**
>
> Although the deregulation of the past few years was a necessary response to marketplace innovations, **it has also substantially limited the ability of regulatory agencies to constrain the risk-taking of insured institutions.** Moreover, this has occurred at a time when there are a number of insured institutions that are operating with impaired capital and have strong incentives to engage in very risky investments. **In light of**

the competitive pressures that the industry will face in the next few years, this deregulation could result in substantial losses. *Id.* at 40-41 (emphasis added).

The report specifically addressed the potential risk to the deposit insurance system of the broadened powers of S&Ls to engage in real estate activities, making the following points:

1. In the real estate business "either bad management or bad luck, or both, . . . can result in substantial losses." *Id.* at 73.

2. The timing of thrifts' entry into the real estate business was not good, because occurring "at the same time that they are facing the need to compete without the protection of deposit interest rate ceilings" and because "the current U.S. economic outlook is rather unfavorable." *Id.*

3. Inflation, which "has played an important role in bailing lenders out of mistakes in real estate lending" is gone; but if real estate prices "do not rise each year, S&Ls may face an increase in credit losses." *Id.*

4. S&Ls are being encouraged to enter these new market areas at a time when "Operating losses in the past couple of years have eroded the net worth positions of S&Ls, reducing their capital cushion." As a result, "Many institutions are simply too weak to restructure their operations toward new business endeavors without assuming undue risks. Some S&Ls may take these excessive risks because they believe that their weakened financial condition leaves them no choice – that is, they believe that they must restructure to survive." *Id.*

5. Federal deposit insurance allows S&Ls to "stay in business even after their capital is depleted because their creditors (depositors) have confidence in the deposit insurance system. Moreover, not only

can these institutions stay in business, they can also obtain the funds they need to undertake risky ventures . . . Now because of their weakened condition, some S&Ls have every incentive to take excessive risks, and this may lead to increased problems in the future. *Id.*

On the adequacy of the FSLIC fund, the FHLBB reported:

> The recent problems of the savings and loan industry, and so of the FSLIC, . . . could have been handled with minimal losses to the insurance fund had the FSLIC closed S&Ls when their real net worth approached zero. However, such a policy would have resulted in the closing of nearly every S&L in the country . . .
>
> The current size of the fund is, of course, inadequate to deal with a drastic deflation and depression of the kind that occurred in the 1930s. **It is inefficient and impractical to require that the fund be large enough to cover the losses associated with such a calamity. Such catastrophes are more appropriately a general obligation of the government than of an insurance fund drawn from user fees.** *Id.* at 18 (emphasis added).
>
> [T]he industry should not be expected to provide a fund adequate for protection against a general collapse of the economy; **it is more appropriate to use the general revenues of the Government to spread the cost of such a collapse across society.** *Id.* at 82 (emphasis added).

The FHLBB acknowledged that its success in dealing with the crisis of the early 1980s by "avoiding both financial

disaster and a loss of public confidence in deposit insurance" is not "wholly reassuring" because "conditions under which the FSLIC fund would not be adequate can readily be imagined." *Id.* at 79.

The FHLBB made nine specific recommendations for assuring the future adequacy of the FSLIC fund. *Id.* at 80–82. Those proposals included re-regulation, which was acknowledged as running "counter to the trend toward less regulation of financial institutions." Other options included reduction in the level of FSLIC coverage, requiring enhanced capital for existing S&Ls (including higher capital requirements for institutions taking greater risk), requiring institutions to pay risk sensitive rather than uniform premiums for deposit insurance, and increasing insurance premiums.

Congress chose not to address the "unstable federal deposit insurance system" by enacting any of the FHLBB's 1983 reform proposals. This industry's capital buffer was not increased. The FSLIC fund was not bolstered by increased uniform premium rates, or by risk based premiums for the institutions that took greater risk. Risk taking was not discouraged through the "pricing mechanisms" of either higher capital requirements, or increased insurance premiums, for institutions that chose to take greater risk for greater potential reward. Nor was risk-taking discouraged by re-regulation.

Congress did, however, enact the Tax Reform Act of 1986, P.L. No. 99-514, 100 Stat. 2085, which eliminated the strong tax incentives[5] that had fueled the real estate boom which had enabled savings and loans to expand their real estate activities under the expanded powers acquired with deregulation. What followed, predictably, was economic

[5] These real estate tax incentives were significantly enhanced by the Economic Recovery Tax Act of 1981, P.L. 97-34, 95 Stat. 172, which coincided with deregulation of the thrift industry.

depression in regions of the country where real estate development was a substantial part of the local economy. As the FHLBB had predicted, with the collapse of real estate values "credit losses" increased dramatically. More than 700 thrifts, generally those that after deregulation had taken on significant real estate exposure, failed. As the FHLBB acknowledged in 1983, the insurance fund was never designed to cover such systemic problems; rather the "general revenues of the government" would be used "to spread the cost of such a collapse across society."

Congress and the President delayed through three election years (two presidential elections) before implementing any of the 1983 reform proposals. They finally responded by enacting FIRREA in 1989. Four years later, the FIRREA Commission – appointed to determine the causes of the thrift debacle – reported on its extensive study of the problem. It concluded that the regulatory policy of allowing thrifts to expand rapidly into riskier businesses on significantly eroded capital bases made the "S&L debacle all but inevitable."[6]

Like the loan guaranty programs in *Yazell* and *Kimbell Foods,* the federal deposit insurance system is "a form of social welfare legislation." *United States v. Kimbell Foods,* 440 U.S. at 735.[7] As the Court held in *Kimbell Foods,* "had Congress intended the private commercial sector [i.e. professionals representing thrift institutions] rather than taxpayers in general, to bear the risks entailed by these

[6] National Commission on Financial Institution Reform, Recovery and Enforcement, *Origins and Causes of the S&L Debacle: A Blueprint for Reform,* A Report to the President and Congress of the United States (U.S. Government Printing Office, Washington, D.C. 1993) 33; 41-43, 43-61.

[7] That social welfare legislation was designed to promote a firmly entrenched national housing policy, and to create a more efficient method of assuring public confidence in the system of savings institutions than market-based methods that would exist in the absence of regulation and deposit insurance. *Agenda for Reform* at 13-16, 40-41.

public welfare programs, it would have" provided that professionals are absolutely liable to FDIC without the necessity that it prove traditional elements of professional liability and without the ability to assert defenses. This it did not do.

If outside professionals failed to meet prevailing state law standards at the time the conduct occurred, they should be held liable. But in light of the policy history, no congressional intent can be discerned or justified to shift to outside professionals who provided services to thrift institutions the societal costs which resulted from increased risks to the FSLIC fund legislated by the taxpayers' elected representatives, from their failure to enact FHLBB recommended reforms, and from systemic failures which under established federal policy were to be "spread . . . across society" using the "general revenues of the Government."

CONCLUSION

The Ninth Circuit's decision defiles a central principle on which the legal profession has operated. It rushes to invent "federal law" to arrive at a result obviously dictated by its own social biases, without demonstrating the necessity of departing from well established, nondiscriminatory state law. This perpetrates a grave injustice on O'Melveny and on the entire American legal profession.

The Petition should be granted, and the Ninth Circuit's decision should be reversed and the case remanded for entry of judgment in favor of O'Melveny.

Respectfully submitted,

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No. 93-489

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS, A LAW PARTNERSHIP,
Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION,
AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK,
ADC FINANCIAL CORPORATION, AMERICAN
DIVERSIFIED/WELLS PARK II, AND AMERICAN
DIVERSIFIED/GATEWAY CENTER,
Respondents,

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

AMICUS CURIAE BRIEF OF BURCH & CRACCHIOLO, P.A. IN SUPPORT OF THE POSITION OF PETITIONER O'MELVENY & MYERS

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Pursuant to Rule 37, Rules of the Supreme Court, the Phoenix, Arizona law firm of Burch & Cracchiolo, P.A. ("B&C"), hereby files this *amicus curiae* brief in support of Petitioner's Writ of Certiorari in the above-captioned case. The written consents of Petitioner and Respondent to the filing of this brief have been obtained and filed with the Clerk.

INTEREST OF *AMICUS CURIAE*

Neither B&C nor any of its clients has any direct pecuniary interest in the underlying lawsuit between Respondent and Petitioner. B&C's interest in the lawsuit derives from its representation of several attorneys, professional organizations and individuals in lawsuits brought by the FDIC/RTC in the aftermath of the collapse of Arizona's real estate economy. B&C has read the petition for review and believes that the accompanying memorandum provides an important additional perspective on the important issues presented in this case.

ARGUMENT FOR GRANTING THE WRIT

I. *THE NINTH CIRCUIT'S RULING IS CAUSING CONFUSION FOR LITIGANTS AS WELL AS ATTORNEYS WHO CONTINUE TO REPRESENT INSURED INSTITUTIONS*

Over the last five to six years, virtually every major savings and loan in the State of Arizona has failed. The FDIC and RTC have responded by bringing claims against many of the most reputable transactional attorneys in Arizona, in most cases alleging that the defendant attorney or law firm should bear full responsibility for failing to prevent the savings and loan client from entering into specific loans or transactions. In these lawsuits the FDIC/RTC is using the decision in *FDIC v. O'Melveny & Myers,* 969 F.2d 744 (9th Cir. 1992), especially Part IV(B) of the opinion, to assert a new and unwarranted federal duty of investigation and disclosure owed by an attorney to the FDIC/RTC.

By suggesting that federal substantive law may effectively prevent imputation to the FDIC/RTC of facts known to and advice received by the institution's officers and directors, the *O'Melveny & Myers* decision threatens to negate decades worth of state law decisions protecting attorneys from negligence claims brought by fully informed and advised corporate clients. *O'Melveny & Myers* sweeps away state law in favor of a sketchily defined retroactive duty of care which suggests, for the very first time, that it is not enough for an attorney to provide competent and complete advice to an insured institution's authorized officers.

Already the FDIC/RTC is using *O'Melveny & Myers* to argue that attorneys for insured institutions effectively owe duties of disclosure and care to the federal regulators themselves. According to the FDIC/RTC's reading of *O'Melveny & Myers*, it is not enough for an attorney to make frank and full disclosure of legal risks to the controlling officers of the institution because the FDIC/RTC need not be bound by such disclosures once it takes over the institution's affairs. Under this reading, an attorney can only obtain complete protection from later suit by the FDIC/RTC by reporting directly to the FDIC/RTC whenever the attorney perceives that the insured client is undertaking a potentially risky transaction or exercising business judgment in a manner that the attorney may question.

Read this way, the *O'Melveny & Myers* decision is causing damage not only by creating confusion in pending professional liability suits, but also by creating uncertainty for those attorneys who currently provide routine services to insured institutions. For example, consider the situation of an Arizona attorney asked by the key officers of an insured institution to document what appears to be a legal but potentially risky loan transaction. Under the well-established law of Arizona and most other states, an attorney may advise her client's agents of the perceived legal consequences of the transaction, but she has no duty to second guess the business judgment of the client's officers, no duty to stop the client from consummating the loan, and no duty or right to report the client's intended actions to the federal regulators.

The *O'Melveny & Myers* decision obscures the otherwise clear guidance of Arizona law by suggesting that if the insured institution is eventually placed in receivership, the FDIC/RTC may sue the institution's attorney unfettered by any imputation to it of the warnings and advice previously rendered by the attorney. Indeed, the attorney's only sure protection from this sort of suit by the FDIC/RTC – short of abandoning representation of insured institutions altogether – is to file a report with the federal regulators describing the institution's intended transaction and the attorney's reservations. To make matters even more confusing, the same "whistle-blowing" mandated by the FDIC/RTC's interpretation of *O'Melveny & Myers* would likely expose the attorney to a malpractice action under Arizona law for breach of confidence.

In short, the *O'Melveny & Myers* decision represents not only a conflict of law among the federal Circuits, but also an unjustified displacement of established state law schemes of professional regulation upon which attorneys, including those in Arizona, have justifiably relied.

II. *THE NINTH CIRCUIT'S RULING CURRENTLY IMPACTS HUNDREDS OF PENDING LAWSUITS INVOLVING BILLIONS OF DOLLARS IN ALLEGED DAMAGES*

The Court should not wait for further Circuit Court of Appeals decisions to address the conflict that has already emerged between the Fifth and Ninth Circuits. The FDIC and RTC currently have hundreds of malpractice suits on file, alleging many billions of dollars in damages, against accounting and legal professionals in states like Arizona and California.

The great majority of these cases involve the assertion of imputation defenses similar to those struck down by the Ninth Circuit on the basis of its newly created federal substantive law. All of these cases will be settled or tried within the next few years under the shadow of the *O'Melveny & Myers* decision unless it is overturned.

CONCLUSION

B&C knows of no similar attempt by any court to define or impose a federal law duty of care for state-licensed and trained attorneys. Traditionally, the licensing and regulating of the conduct and duties of attorneys have been left to the States. The Ninth Circuit, without support or precedent, has unwisely jettisoned this large body of law and regulation in favor of a newly announced federal duty designed solely to enhance the ability of the FDIC/RTC to sue and reach insured third party professional defendants. The *O'Melveny & Myers* decision thus raises issues that go to the heart of federalism. If the decision stands it will create enormous confusion not only in pending FDIC/RTC litigation suits against attorneys and their law firms, but also for those law firms currently representing financial institutions. Petitioner's petition for a writ of certiorari should be granted.

Respectfully submitted this 28th day of October, 1993.

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No. 93-489

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS, A LAW PARTNERSHIP,
Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION,
AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK,
ADC FINANCIAL CORPORATION, AMERICAN
DIVERSIFIED/WELLS PARK II, AND AMERICAN
DIVERSIFIED/GATEWAY CENTER,
Respondents,

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF MEYER, HENDRICKS, VICTOR, OSBORN & MALEDON, P.A., AS *AMICUS CURIAE* IN SUPPORT OF THE POSITION OF PETITIONER

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Pursuant to Rule 37, Rules of the Supreme Court, the Phoenix, Arizona law firm of Meyer, Hendricks, Victor, Osborn & Maledon, P.A. ("MHVOM") files this *amicus curiae* brief in support of Petitioner's Writ of Certiorari in the above-captioned case. The written consents of Petitioner and Respondent to the filing of this brief have been filed with the Clerk.

INTEREST OF *AMICUS CURIAE*

Neither MHVOM nor any of its clients has any direct pecuniary interest in the underlying lawsuit between Respondent and Petitioner. MHVOM's interest in the lawsuit derives from its representation of numerous local law firms and other professional organizations and individuals in lawsuits brought by the FDIC/RTC. MHVOM has read the petition for certiorari and believes that the accompanying memorandum provides an additional perspective on the important issues presented in this case.

ARGUMENT FOR GRANTING THE WRIT

I. *THE NINTH CIRCUIT'S RULING IS CAUSING CONFUSION FOR LITIGANTS AS WELL AS ATTORNEYS WHO CONTINUE TO REPRESENT INSURED INSTITUTIONS*

Over the last five to six years, virtually every major savings and loan in Arizona has failed. The FDIC and RTC have responded by suing many of the most reputable transactional attorneys in Arizona, in most cases alleging that the defendant attorney or law firm should bear full responsibility for failing to prevent the savings and loan client from entering into specific loans or transactions. The enormous costs of defending these professional liability suits, coupled with uncertain standards and the risk of catastrophic damage exposure, have forced defendants to settle these actions, regardless of the merits of the underlying claims.

FDIC v. O'Melveny & Myers, 969 F.2d 744 (9th Cir. 1992) (hereafter "*O'Melveny*"), especially Part IV(B) of the

opinion, has now made a difficult situation worse by threatening to give birth to a new and unwarranted federal duty of investigation and disclosure, purportedly owed by an attorney to the FDIC/RTC.

By suggesting that federal substantive law may effectively prevent imputation to the FDIC/RTC of facts known to and advice received by the institution's officers and directors, the decision below threatens to negate decades of state law decisions protecting attorneys from negligence claims brought by fully informed and advised clients. *See e.g. Fridena v. Evans,* 127 Ariz. 516, 622 P.2d 463 (1980); *Hughes v. The Riggs Bank,* 29 Ariz. 44, 239 P. 297 (1925). *O'Melveny* sweeps away this settled state law in favor of a sketchily defined retroactive duty of care which suggests, for the very first time, that it is not enough for an attorney to provide competent and complete advice to an insured institution's authorized officers.

The FDIC/RTC is already using *O'Melveny* to argue that attorneys for insured institutions effectively owe duties of disclosure and care to the federal regulators themselves. According to the FDIC/RTC's reading of *O'Melveny* it is not enough for an attorney to make frank and full disclosure of legal risks to the controlling officers of the institution. Rather, the FDIC/RTC argues that an attorney can only obtain complete protection from later suit by a federal receiver by reporting directly to the FDIC/RTC whenever the attorney perceives that the insured client is undertaking a potentially risky transaction or exercising business judgment in a manner that the attorney may question.

Thus, *O'Melveny* not only creates confusion in pending professional liability suits, but also adds uncertainty for those attorneys who currently provide routine services to insured institutions. Consider the situation of an Arizona attorney asked by the key officers of an insured institution to document what appears to be a legal but potentially risky loan transaction. Under the well-established law of Arizona and most other states, an attorney may advise her client's agents of the perceived risks, but she has no duty to second guess the business judgment of the client's officers, no duty to stop the client from consummating the loan, and no duty

or right to run to the federal regulators to report the client's intended actions.

O'Melveny obscures the otherwise clear guidance of Arizona law by suggesting that if the insured institution is eventually placed in receivership, the FDIC/RTC may sue the institution's attorney unfettered by any imputation to it of the warnings and advice previously rendered by the attorney. Indeed, the attorney's only sure protection from this sort of suit by the FDIC/RTC – short of abandoning representation of insured institutions altogether – is to file a report with the federal regulators describing the institution's intended transaction and the attorney's reservations. To make matters even more confusing, the same "whistle-blowing" mandated by the FDIC/RTC's interpretation of *O'Melveny* would likely expose the attorney to a malpractice action under Arizona law for breach of confidence.

In short, *O'Melveny* not only conflicts with decisions of other Circuits, but also unjustifiedly displaces established state law schemes of professional regulation upon which attorneys, including those in Arizona, have long relied.

II. *THE NINTH CIRCUIT'S RULING CURRENTLY IMPACTS HUNDREDS OF PENDING LAWSUITS INVOLVING BILLIONS OF DOLLARS IN ALLEGED DAMAGES*

The Court should not wait for other Circuits to address the conflict that has already emerged between the Fifth and Ninth Circuits. The FDIC and RTC currently have hundreds of malpractice suits on file, alleging many billions of dollars in damages, against accounting and legal professionals in states like Arizona and California.

The great majority of these cases involve the assertion of imputation defenses similar to those struck down by the Ninth Circuit on the basis of its newly created federal substantive law. All of these cases will be settled or tried within the next few years under the shadow of *O'Melveny* unless it is overturned or clarified.

CONCLUSION

Traditionally, the licensing and regulating of the conduct and duties of attorneys have been left to the States. The Ninth Circuit, without support or precedent, has unwisely jettisoned a large body of law and regulation in favor of a newly announced federal duty designed solely to enhance the ability of the FDIC/RTC to sue insured third party professional defendants. *O'Melveny* thus raises issues that go to the heart of federalism. If the decision stands it will create enormous confusion not only in pending FDIC/RTC litigation suits against attorneys and their law firms, but also for those law firms currently representing financial institutions. The petition for a writ of certiorari should be granted.

Respectfully submitted this 28th day of October, 1993.

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No. 93-489

In The

SUPREME COURT OF THE UNITED STATES

October Term, 1993

O'Melveny & Myers, A Law Partnership,

Petitioner,

v.

Federal Deposit Insurance Corporation As Receiver For American Diversified Savings Bank, et al.,

Respondents.

Petition for a Writ of Certiorari
To the United States Court of Appeals
For the Ninth Circuit

BRIEF AMICUS CURIAE BY BUSINESS LAWYERS IN SUPPORT OF PETITIONER

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For the Ninth Circuit

BRIEF AMICUS CURIAE BY BUSINESS LAWYERS IN SUPPORT OF PETITIONER

I. INTEREST OF AMICI CURIAE

Pursuant to Rule 36.1 of Rules of this Court, this brief amicus curiae is being submitted by counsel experienced in business and securities law to urge the

Court to grant the petition of O'Melveny & Myers (the "Firm") for the issuance of a writ of certiorari to review the decision of the Ninth Circuit in FDIC v. O'Melveny & Meyers [sic], 969 F.2d 744 (1992) (hereinafter, "O'Melveny" or the "Decision").[1] The articulated premise of the Ninth Circuit's opinion rejecting the Firm's claims of estoppel is that the Firm owed a duty to the investors in the partnerships organized by the Firm's client to conduct a due diligence investigation of the offering circulars used to offer and sell interests in the partnerships. No such duty exists. The Ninth Circuit's articulation of this purported principle of law is at odds with rulings on the issue in the Second, Fourth, Fifth, Seventh, Eighth, and Tenth Circuits.

Were the Ninth Circuit's pronouncements on the duties of securities counsel to become the law of the Ninth

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[1] The firms joining in the request made by this brief are listed on the signature page hereto.

Circuit, securities counsel would be shouldered with a burden they realistically cannot bear. Inevitably, only the largest firms could continue with a securities practice, and then only at a cost to issuing companies that would make it much more difficult for smaller companies to access the capital markets.

The undersigned have sought and obtained the consent of both petitioner and respondents to the filing of this brief urging the Court to accept the Firm's petition for a writ of certiorari. The consent letters are being filed with the signed original of this brief.

II. STATEMENT

This lawsuit arose from the ashes of two partnerships that were terminated shortly after their organization, upon the FDIC's discovery that the private placement memoranda used to market the two partnerships omitted material facts, primarily regarding the financial condition of American Diversified Savings

Bank ("ADSB"), the corporate parent of the general partners of the partnerships. The Firm assisted the general partner in drafting the two private placement memoranda. No contention is made that the Firm had knowledge of the facts omitted from the private placement memoranda.

The source of the fraud can be traced to the feet of the two principal officers of ADSB. The focus of the litigation became, therefore, whether the FDIC was estopped from asserting its claims of professional malpractice, negligent misrepresentation, and breach of fiduciary duty against the Firm by the misconduct of these two principal officers. The District Court ruled that the FDIC's claims were extinguished by the officers' misconduct; the Ninth Circuit ruled they were not.

Fundamental to the Ninth Circuit's conclusion, and the premise from which it launched into its analysis of the estoppel issues, are its observations and pronouncements

on the duties of securities counsel. While arguably these observations and pronouncements are *dicta*, in that the question of the duties of securities counsel to investors was not presented to the Ninth Circuit, because the pronouncements are so fundamental to the Court's rulings, so wrong, and may be accepted as controlling by lower courts throughout the Ninth Circuit, they constitute an independent ground on which this Court should grant the Firm's petition to issue a writ of certiorari to review the Decision.

Before the Ninth Circuit, the FDIC argued that it was axiomatic that the Firm, as securities counsel, was duty bound to ensure that ADSB's private placement memoranda were true and complete:

> O'Melveny had a duty, as securities counsel to ADSB, to use due care to learn readily available material facts about ADSB and to cause those facts to be disclosed to potential investors. While there was unquestionably wrongdoing by some insiders at ADSB, this wrongdoing in no way prevented O'Melveny from doing its job. Had O'Melveny

done its job properly, the losses to ADSB and to the investors would not have occurred.[2]

The FDIC relied heavily upon Judge Smith's 1978 opinion for the Northern District of Mississippi in Felts v. National Accounts Systems Ass'n, Inc., 469 F. Supp. 54 (N.D. Miss 1978) ("Felts"), wherein Judge Smith ruled that securities counsel has a duty "to exercise due diligence, including a reasonable inquiry, in connection with responsibilities he has voluntarily undertaken." *Id.* at 67. Citing Judge McLean's famous opinion in Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) ("BarChris"), Judge Smith concluded that securities counsel must make a "reasonable, independent investigation to detect and correct false or misleading materials." *Id.*

The Ninth Circuit, in its opinion by Judge Poole,

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[2] Appellants' Opening Brief Before the Ninth Circuit, dated October 31, 1990, at 2-3.

adopted the argument of the FDIC. Seizing upon a hypothetical statement by the Firm that, even if securities counsel owes a duty of due diligence to investors, it owes *no* such duty to the issuer under the circumstances present in this case, Judge Poole concluded that if securities counsel owes a duty of due diligence to investors, it must also owe a duty of due diligence to its client -- the issuer. O'Melveny "concedes," states Judge Poole, "the existence of a duty by a principal and its agent of complete and accurate disclosure to potential investors in a securities offering, but argues . . . that the agent owes no additional duty to the successor in interest of a principal to make inquiries and disclose information which, the Firm argues, the principal already knew and was trying to conceal." 969 F.2d at 748. Whatever force this argument had, the Ninth Circuit simply could not stomach the claim when made against the government agency "created by Congress to rescue the economy and the victims of failing thrifts. . ."

Id. That the FDIC should be frustrated in rescuing the economy by the fraud committed by prior management of a thrift was a proposition found "incredible" by the Ninth Circuit, particularly when applied "to the duties of attorneys retained to give advice and assistance with respect to public offerings." *Id.*

Hewing closely to the line of argument pressed upon it by the FDIC, the Ninth Circuit refused to accept the distinction between counsel's duty to investors and counsel's duty to its client:

> Given a broad duty to protect the client, this distinction [between the duty to investors and the duty to the client] is a false one. Part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors. An important duty of securities counsel is to make a "reasonable independent investigation to detect and correct false or misleading materials." [citing Felts] This is what is meant by a due diligence investigation. Koehler v. Pulvers, 614 F. Supp. 829, 845 (S.D. Cal. 1985) (due diligence required lawyer's independent investigation of information supplied by issuer for incorporation

> into offering materials.) The Firm [O'Melveny] had a duty to guide the thrift as to its obligations and to protect it against liability. In its high specialty field, O'Melveny owed a duty of due care not only to the investors, but also to its client, ADSB.

969 F.2d at 749.

III. ARGUMENT

A. THE NINTH CIRCUIT'S PRONOUNCEMENTS ON THE DUTIES OF SECURITIES COUNSEL ARE AT ODDS WITH RULINGS OF THE SECOND, FOURTH, FIFTH, SEVENTH, EIGHTH, AND TENTH CIRCUITS

The fullest treatment of the duties of securities counsel to investors or to third parties other than counsel's client can be found in Judge McLean's opinion in BarChris, *supra* at page 6, in the Fourth Circuit's opinion in Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992), and in the Seventh Circuit's decision in Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986). These and the other cases that have addressed the question establish that

counsel is not liable for the misstatements of fact by others unless counsel has a specific duty to investigate a client's statement of facts *and* a duty to disclose the results of that investigation. No such duty to investigate the veracity of the representations of fact contained in an offering circular is imposed upon counsel by Sections 11 or 12 of the Securities Act of 1933, as amended (the "Securities Act"), 15 U.S.C. §§ 77k, 77*l* (1988), or by Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), 15 U.S.C. § 78j(b) (1988) or Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1993). *See* Fortson v. Winstead, McGuire, Sechrest & Minick, 961 F.2d 469, 472-475 (4th Cir. 1992); Ackerman v. Schwartz, 947 F.2d 841, 844-848 (7th Cir. 1991); Camp v. Dema, 948 F.2d 455, 459-461, 463-464 (8th Cir. 1991); Abell v. Potomac Insurance Co., 858 F.2d 1104, 1123-1128 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989). *See also* Windon Third Oil and Gas

Drilling Partnership v. FDIC, 805 F.2d 342, 346-347 (10th Cir. 1986) *cert. denied*, 480 U.S. 947 (1987) (accountants owe no duty of due diligence to an issuer's investors under Rule 10b-5).[3]

The rulings in each of these cases are directly contrary to the pronouncements of the Ninth Circuit in O'Melveny that securities counsel has a duty to make a

[3] A lawyer may, of course "expertise" portions of a registration statement, such as by the issuance of a tax opinion, in which event counsel would take on the responsibilities of an expert pursuant to Section 11 of the Securities Act, 15 U.S.C. § 77k. *See* Judge McLean's discussion of this issue in BarChris, *supra* page 6, 283 F. Supp. at 683.

The only circuit in which one can find an echo of support for the Ninth Circuit's pronouncements on the duties of securities counsel in O'Melveny is the Sixth Circuit's opinion in Molecular Technology Corp. v. Valentine, 925 F.2d 910 (6th Cir. 1991), wherein the Court, without citation, pronounces that securities counsel owes a duty under Rule 10b-5 to disclose to investors material facts of which counsel is *aware* in connection with counsel's review of a prospectus prepared by other counsel. *See id.* at 917-918.

"reasonable independent investigation to detect and correct false or misleading materials." 969 F.2d at 749 (citing Felts). The rulings in these cases contradict the Ninth Circuit even though in most of them the allegation was made that counsel had *some knowledge* of the inaccuracy of the prospectus or transaction documents; here, no allegation has been made that O'Melveny had any knowledge of the precarious financial condition of ADSB, the source of the misstatements in the two private placement memoranda the Firm assisted the partnerships in preparing.

B. THE TWO FEDERAL DECISIONS ON WHICH THE NINTH CIRCUIT RELIED TO REACH ITS CONCLUSION ON THE DUTIES OF SECURITIES COUNSEL DO NOT SUPPORT ITS CONCLUSION

The Ninth Circuit relies on two Federal decisions in concluding that securities counsel owes a duty of due diligence to investors, Felts and Koehler v. Pulvers, cited *supra* at pages 5-6 and 9. In Felts Judge Smith misread

Judge McLean's ruling in BarChris. Indeed, Judge Smith turned Judge McLean's ruling on the duties of securities counsel on its head. Judge McLean ruled that an issuer's securities counsel is *not* an expert for purposes of Section 11 of the Securities Act, and therefore has no duty to conduct a due diligence investigation of the registration statement. 283 F. Supp. at 683.

Judge Enright's opinion in Koehler v. Pulvers, 614 F. Supp. 829 (S.D. Cal. 1985) likewise provides no support for the Ninth Circuit's opinion. Despite extensive evidence of counsel's direct and purposeful participation in marketing securities, and knowledge that the private placement memorandum was materially misleading, Judge Enright nevertheless concluded that counsel did not possess the requisite scienter for liability under Rule 10b-5. 614 F. Supp. at 836, 838-840, 845-848. Koehler cannot be read as imposing a duty of due diligence upon securities counsel.

C. THE NINTH CIRCUIT'S PRONOUNCEMENTS ON THE DUTIES OF SECURITIES COUNSEL FINDS NO SUPPORT IN CALIFORNIA LAW

Space limitations prevent a detailed critique of the Ninth Circuit's ruling on the duties of securities counsel under California state law. Suffice to say that these pronouncements find no support under California statutory or case law. *See* 1 H. Marsh and R. Volk, Practice Under The California Securities Laws §§ 14.03[4], [4A] (1993); Goodman v. Kennedy, 18 Cal. 3d 335, 134 Cal. Rptr. 375 (1976); Roberts v. Ball, Hunt, Hart, Brown & Baerwitz, 57 Cal. App. 3d 104, 128 Cal. Rptr. 901 (2nd Dist. 1976). *See also* Bily v. Arthur Young & Company, 3 Cal. 4th 370, 11 Cal. Rptr. 2d 51 (1992). For a detailed discussion, see Fotenos, "FDIC v. O'Melveny & Myers: Does Securities Counsel Owe To Investors and To Its Client a Duty To Conduct a Due Diligence Investigation of the Offering?", 15 Bus. Law News 3, 40-43 (Cal. State Bar, Business Law Section, Winter 1993).

D. THE NINTH CIRCUIT'S PRONOUNCEMENTS ON THE DUTIES OF SECURITIES COUNSEL WILL HAVE A DELETERIOUS EFFECT UPON THE PRACTICE OF SECURITIES LAW, AND CAPITAL FORMATION, IN THE NINTH CIRCUIT

The burden of conducting a due diligence investigation of a securities offering is one that securities counsel to an issuer cannot realistically shoulder. Congress is quite specific, in Section 11 of the Securities Act, as to who is responsible for conducting a due diligence investigation of a securities offering: the underwriter and those who sign the registration statement (the chief executive, financial, and accounting officers and the directors). Experts who specifically prepare a portion of the registration statement or an opinion incorporated therein are assigned due diligence responsibilities with respect to those portions of the registration statement prepared by them or with respect to the opinion rendered

by them.[4] Each of these parties is uniquely situated to bear the responsibility of conducting a due diligence investigation of the offering. Underwriters maintain extensive research staffs, which continually monitor the industries in which their clients operate, and the specific business of their clients (or potential clients). Officers spend their full time in the business of the issuer. Directors have a continuing involvement with the business of the issuer, and gain intimate knowledge thereof through the discharge of their oversight responsibilities.

Securities counsel is retained not to conduct a factual investigation of an issuer's business, but to assist the issuer in wending its way through the complicated statutory requirements and rules governing the preparation of a registration statement and the offer and sale of

[4] As indicated above at pages 12-13, the fact that counsel may assist the issuer in drafting a registration statement does not make counsel a statutory expert for purposes of Section 11.

securities. In this, counsel plays an advisory role, leaving to the issuer and its officers and employees the task of providing accurate information about the issuer's business and the risks attendant to operating that business. Often in the process of preparing a registration statement, an issuer's counsel may negotiate for the issuer with the underwriter and with the underwriter's counsel over disclosure questions.

Imposing upon securities counsel a due diligence obligation not found in existing law would upset the delicate balance crafted by Congress in allocating due diligence obligations, and would disrupt the capital formation process.[5] If securities counsel is to be held to

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[5] The imposition of a broad duty of verification is not in accordance with present practice and would not only constitute a wasteful use of the attorney's professional talents, but might also impose economically unfeasible burdens on the client.

(*cont.*)

a due diligence obligation, then such counsel will of necessity focus its energy not only upon assisting its client, but also upon building a record to insulate itself from potential liability. In the process, counsel's duty of maintaining in confidence information relating to the representation may be compromised.[6]

Not only would the practice of securities law have to change dramatically if the Ninth Circuit's pronouncements on the duties of securities counsel establish the law in the Ninth Circuit, but inevitably the substantially increased risk to counsel would limit the practice only to the largest firms or those firms heedless

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Small, "An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor Or Public Servant?" 61 Cal. L. Rev. 1189, 1214 (1973).

[6] *See* ABA, Model Rules of Professional Conduct, Rule 1.6, and ABA, Model Code of Professional Responsibility, Canon 4 and Disciplinary Rule 4-101; Cal. Bus. & Prof. Code § 6068(e) (West 1990).

of risk. A necessary further consequence would be to increase the cost of accessing the capital markets by issuers of securities. Neither of these consequences is desirable.

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IV. CONCLUSION

For the foregoing reasons, the undersigned urge the Court to grant the petition by O'Melveny & Myers for a writ of certiorari.

Dated: October 26, 1993

Respectfully submitted,

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No. 93-489

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

O'MELVENY & MYERS,
a Law Partnership,
Petitioner,
v.

FEDERAL DEPOSIT INSURANCE CORPORATION as RECEIVER for AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS PARK II, and AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR CERTIORARI FILED SEPTEMBER 27, 1993
CERTIORARI GRANTED NOVEMBER 29, 1993

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Date	No.	PROCEEDINGS
06/29/92	24	Opinion (reversing district court grant of summary judgment)
07/06/92	25	MOTION OF APPELLEE O'MELVENY & MYERS FOR EXTENSION OF TIME TO FILE PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC; FORM OF PROPOSED ORDER
07/27/92	26	APPELLEE'S PETITION FOR REHEARING AND SUGGESTION OF REHEARING EN BANC
6/30/93	64	Ninth Circuit Court of Appeals Order Denying Petition for Rehearing

[Filed May 12, 1989]

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

No. CV 89-2877 TJH (KX)

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK; ADC FINANCIAL CORPORATION, a California corporation; AMERICAN DIVERSIFIED/WELLS PARK II, a California Limited Partnership, formerly known as American Diversified/Wells Park; and AMERICAN DIVERSIFIED/GATEWAY CENTER, a California limited partnership,

Plaintiffs,

vs.

O'MELVENY & MYERS,
a law partnership,

Defendant.

COMPLAINT FOR PROFESSIONAL NEGLIGENCE; NEGLIGENT MISREPRESENTATION; BREACH OF FIDUCIARY DUTY; AND EQUITABLE INDEMNITY AND CONTRIBUTION

JURY TRIAL DEMANDED

Plaintiff Federal Savings and Loan Insurance Corporation ("FSLIC") for its complaint alleges as follows:

JURISDICTION AND VENUE

1. This Court has jurisdiction of this action pursuant to 28 U.S.C. §§ 1331 and 1345, 12 U.S.C. § 1730(k)(1), and the doctrine of pendent jurisdiction.

2. Venue is proper in this the Central District of California under 28 U.S.C. § 1391 and is proper in the Santa Ana Division thereof under 28 U.S.C. § 1393(a). The claims asserted in this complaint arose in said district and said division in that the contract with defendant was entered into in Orange County, California, and the professional services at issue in this litigation were performed in Orange County, California. The defendant is now and at all relevant times was a resident of and transacted substantial business in Orange County, California.

PARTIES

3. FSLIC is a corporation and an instrumentality of the United States, authorized to sue by act of Congress. 12 U.S.C. § 1725(c). FSLIC operates under the direction of the Federal Home Loan Bank Board (the "Bank Board"), and has its principal office in the District of Columbia. 12 U.S.C. § 1725(a). FSLIC has been charged by Congress with responsibility to maintain the financial stability of the savings and loan industry throughout the United States and to protect the creditors and depositors of savings and loan institutions through the creation, maintenance and protection of the FSLIC fund. 12 U.S.C. §§ 1724, 1726(a), (b), 1729(f), 1730(m). FSLIC maintains this action as part of its duties and responsibilities to maintain and protect the FSLIC fund and for the benefit of depositors and creditors of American Diversified Savings Bank.

4. American Diversified Savings Bank ("ADSB") was a savings and loan association chartered under the laws of the State of California, whose deposits were insured by FSLIC. At all relevant times, ADSB had its principal place of business in Costa Mesa, California.

5. On February 14, 1986, the Bank Board determined that ADSB was insolvent, had substantially dissipated its assets due to violations of law and unsafe and unsound practices, and was in an unsafe and unsound condition to

transact business. The Bank Board appointed FSLIC as the Conservator for ADSB.

6. FSLIC took possession of ADSB on February 14, 1986. As Conservator, FSLIC succeeded to the rights, title, powers and privileges of ADSB and to the rights, powers and privileges of the directors and officers of ADSB. 12 U.S.C. § 1729(c)(1)(B)(II); 12 C.F.R. Part 548.2(b).

7. On June 3, 1988, the Bank Board appointed FSLIC as Receiver for ADSB. As receiver, FSLIC succeeded to the rights, title, powers and privileges of the directors and officers of ADSB. 12 U.S.C. § 1729(c)(1)(B)(II).

8. American Diversified Capital Corporation ("ADCC") is and at all times has been a corporation, organized and existing under the laws of the State of California, wholly owned by ADSB. ADCC is classified as a service corporation of ADSB and, at all relevant times, its operations were subject to regulation by FSLIC. At all relevant times, ADCC had its principal place of business in Costa Mesa, California.

9. ADC Financial Corporation ("ADC Financial") is, and at all relevant times, has been a corporation, organized and existing under the laws of the State of California, wholly owned by ADCC. ADC Financial is classified as a service corporation of ADSB and, at all relevant times, its operations were subject to regulation by FSLIC. ADC Financial is the general partner of American Diversified/Wells Park II, a California Limited Partnership, formerly known as American Diversified/Wells Park, a California Limited Partnership ("Wells Park"). ADC Financial is also the general partner of American Diversified/Gateway Center, a California Limited Partnership ("Gateway Center"). Wells Park and Gateway Center are, and at all relevant times have been, limited partnerships organized and existing under the laws of the State of California. At all relevant times, ADC Financial, Wells Park and Gateway Center had their principal place of business in Costa Mesa, California.

10. Defendant O'Melveny & Myers is, and at all relevant times was, a law partnership residing in and doing business in Orange County, California. In 1985, the Orange County office of O'Melveny & Myers was retained by ADSB, ADC Financial, Wells Park and Gateway Center as special securities counsel and tax counsel with respect to the offering to potential investors of limited partnership units in Wells Park and Gateway Center.

FACTUAL ALLEGATIONS PERTAINING TO WELLS PARK

11. Wells Park was and is involved in the acquisition, rehabilitation and operation of a commercial building located in Portland, Oregon, the acquisition, development and operation of an apartment complex in Nashville, Tennessee, and the acquisition and operation of an apartment complex in Tampa, Florida.

12. Limited partnership units in Wells Park were offered for sale to investors pursuant to a Private Placement Memorandum dated October 17, 1985 (the "Wells Park PPM"). Pursuant to the Wells Park PPM, on or about December 31, 1985, Wells Park sold 79 limited partnership units at a price per unit of $100,000 to unaffiliated investors (the "Wells Park Investors"), and sold 21 units at a price per unit of $90,500 to an affiliate of ADC Financial, American Diversified Technical Corporation I, a wholly owned subsidiary of ADCC ("Wells Park Offering").

13. As special securities and tax counsel for the Wells Park Offering, defendant O'Melveny & Myers was required to conduct and participate in an investigation into the business operations, prospects and financial accounting and management control systems of Wells Park, known as "due diligence" investigation, and participated in the

preparation of the Wells Park PPM, including but not limited to drafting substantial portions thereof and reviewing financial statements and other documents included therein.

14. The Wells Park PPM prepared by defendant and others projected the image of Wells Park as a well-run partnership whose general partner was experienced with similar limited partnerships that had been successful. It projected the image of ADC Financial as a sound business affiliated with a major savings and loan association with a very substantial net worth. The PPM contained financial statements of ADC Financial that indicated that ADC Financial's total assets of $8,510,634 included a $4,975,000 certificate of deposit with ADSB. The Wells Park PPM stated that ADSB had informed ADC Financial that "current regulations and circumstances would permit ADSB to provide [ADC Financial] and affiliates with funds projected to be needed by them from ADSB." The Wells Park PPM contained projections based on prior performance of its general partner, ADC Financial, and affiliated entities in other limited partnerships, which suggested that these limited partnerships were financially sound, and created the impression that ADC Financial was a seasoned general managing partner of comparable limited partnerships with a strong track record.

15. The statements particularized in paragraph 14 above were false and misleading when made by defendants and no adequate or reasonable basis existed to justify or support such statements. Plaintiffs are informed and believe and thereupon allege that the true facts, which were recklessly disregarded by defendant O'Melveny & Myers, who failed to disclose them when under a duty to do so, are as follows:

(a) ADSB was at the time of the Wells Park Offering, and had been at least since the close of its most recent fiscal year, ended June 30, 1985, in serious financial difficulties. As a result: (1) there was a significant risk that ADSB would be unable or unwilling to infuse its subsidiaries, and through them its second tier subsidiaries like ADC Financial, with additional capital contributions; (2) there was a significant risk that ADSB would be unable or unwilling to make loans to its subsidiaries, second tier subsidiaries, or other affiliates; (3) ADSB faced a serious risk of failing as a going concern; (4) ADSB faced a serious risk of being placed in receivership or conservatorship by the FSLIC; (5) there was a real danger that, if ADSB were to fail or be placed in receivership or conservatorship, its affiliates, including Wells Park, would also fail for numerous reasons; and (6) if ADSB were to fail or be placed in receivership, there was a significant risk that ADC Financial would lose the uninsured portion of the $4,975,000 it had in its certificate of deposit with ADSB.

(b) ADSB and its auditors were delinquent in producing audited financial statements for the year ended June 30, 1985, which delinquency was an indication of serious record-keeping, management and financial shortcomings at ADSB.

(c) ADSB was in violation of federal regulations and in violation of a regulatory agreement entered into between ADSB and CDSL on or about October 14, 1984, which restricted ADSB's aggregate direct investments, including its investments in its wholly-owned service corporations, to 60% of assets, and required it to maintain a net worth of no less than 5% of total assets, and was in violation of various other regulatory restrictions, an indication of serious management, accounting and financial shortcomings; and that these restrictions would prohibit or restrict ADSB from further capital contributions to its subsidiaries or second tier subsidiaries that might be necessary to maintain those entities as viable concerns.

(d) ADSB was in violation of its duty to keep adequate records, indicating a serious failure in management, financial and accounting controls.

(e) The financial statements of ADC Financial contained in the PPM were false and misleading because (1) ADC Financial's net worth was dependent upon a $4,975,000 certificate of deposit with ADSB, yet the financial statements failed to disclose the problems with ADSB described above, including the material risk associated with the uninsured certificate of deposit; (2) the balance sheet contained in the financial statements for ADC Financial was outdated; (3) Arthur Young & Company ("Arthur Young"), who prepared the balance sheet, had not authorized ADC Financial to use it in connection with the Wells Park private placement.

(f) ADC Financial had begun marketing another private placement offering for American Diversified/Hickory Trace, a California Limited Partnership ("Hickory Trace"), pursuant to a private placement memorandum dated August 1, 1985 ("Hickory Trace PPM"), which offering was withdrawn in December, 1985, prior to the Wells Park sale of limited partnership units on December 31, 1985, because of the insistence of outside securities counsel that potential investors be provided with audited financial statements of ADSB for its most recent fiscal year, which statements were unavailable.

16. In light of the facts set forth in paragraph 15 (a)-(f), the purchase of the Wells Park limited partnership units involved a very high degree of risk.

17. The adverse information not disclosed by defendant was material information as to which a reasonable person would attach importance in making the decision whether to purchase the Wells Park limited partnership units.

18. Plaintiffs are informed and believe and thereupon allege that defendant O'Melveny & Myers, as special securities counsel and tax counsel for the Wells Park Offering, should have discovered the facts set forth in paragraph 15 above in the exercise of reasonable diligence and caused said facts to be set forth in the Wells Park PPM. Instead, defendant O'Melveny & Myers failed to make any significant inquiry into the matters set forth in paragraph 15 above. Among other things, defendant O'Melveny & Myers failed to make any inquiry whatsoever with the outside public auditors for ADSB, ADCC or ADC Financial, failed to make any inquiry whatsoever with prior outside securities counsel for ADC Financial, and failed to make any inquiry whatsoever into the financial condition or regulatory status of ADSB and its service corporation subsidiaries.

19. On or about October 17, 1986, ADC Financial, Wells Park and FSLIC, then Conservator of ADSB, offered to the Wells Park Investors an opportunity to rescind their investments in Wells Park by selling their Wells Park limited partnership units to Wells Park ("Wells Park Rescission Offer"). Pursuant to the Wells Park Rescission Offer, rescinding investors would receive in exchange for their units, the principal amount of the consideration paid by said investor, plus interest thereon.

20. Each of the Wells Park Investors accepted the Wells Park Rescission Offer and transferred his or her limited partnership units to ADC Financial. As part of said rescission, each Wells Park Investor also assigned to FSLIC, as Conservator for ADSB, all rights, causes of action and claims, in connection with the Wells Park Offering, which the investor may have against all persons involved in the Wells Park Offering with respect to any violations of the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act"), or the securities laws or common law of any state.

21. Defendant O'Melveny & Myers has entered into written agreements tolling the statute of limitations for

claims arising out of the Wells Park Offering for the period December 23, 1986 through May 15, 1989.

FACTUAL ALLEGATIONS PERTAINING TO GATEWAY CENTER

22. Gateway Center was and is involved with the acquisition, rehabilitation and operation of a commercial property located in San Francisco, California, the acquisition, development and operation of an apartment complex located in Palmdale, California, and the acquisition and operation of an office building located in El Paso, Texas.

23. Limited partnership units in Gateway Center were offered for sale to investors pursuant to a private placement memorandum dated November 25, 1985 (the "Gateway Center PPM"). Pursuant to the Gateway Center PPM, on or about December 31, 1985, Gateway Center sold 61 limited partnership units at a price per unit of $100,000 to unaffiliated investors (the "Gateway Center Investors"), sold 48.25 units at a discount to an affiliate of ADC Financial, American Diversified Technical Corporation II, and sold 10.75 units at a discount to American Diversified Executive Partnership, a California Limited Partnership, the general partner of which is ADCC and the limited partners of which are current or former employees of ADSB and its affiliates ("Gateway Center Offering").

24. As special securities and tax counsel for the Gateway Center Offering, defendant O'Melveny & Myers conducted or participated in an investigation into the business operations, prospects and financial accounting and management control systems of Gateway Center, known as "due diligence" investigation, and participated in the preparation of the Gateway Center PPM, including but not limited to drafting substantial portions thereof and reviewing financial statements and other documents included in the Gateway Center PPM.

25. The Gateway Center PPM prepared by defendant and others projected the image of Gateway Center as a well-run partnership whose general partner was experienced with, and had a track record of, similar limited partnerships that had been successful. It projected the image of ADC Financial as a sound business affiliated with a major savings and loan association with a very substantial net worth. The PPM contained financial statements of ADC Financial that indicated that ADC Financial's total assets of $8,510,634 included a $4,975,000 certificate of deposit with ADSB. The Gateway Center PPM stated that ADSB had informed ADC Financial that "current regulations and circumstances would permit ADSB to provide [ADC Financial] and affiliates with funds projected to be needed by them from ADSB." The Gateway Center PPM contained projections based on prior performance of its general partner, ADC Financial, and affiliated entities in other limited partnerships, which suggested that these limited partnerships were financially sound, and created the impression that ADC Financial was a seasoned general managing partner of comparable limited partnerships with a strong track record.

26. The statements particularized in paragraph 25 above were false and misleading when made by defendants and no adequate or reasonable basis existed to justify or support such statements. Plaintiffs are informed and believe and thereupon allege that the true facts, which were recklessly disregarded by defendant O'Melveny & Myers, who failed to disclose them when under a duty to do so, are as follows:

(a) ADSB was, at the time of the Gateway Center Offering and had been at least since the close of its most recent fiscal year, ended June 30, 1985, in serious financial difficulties. As a result: (1) there was a significant risk that ADSB would be unable or unwilling to infuse its subsidiaries, and through them its second tier subsidiaries like ADC Financial, with

additional capital contributions; (2) there was a significant risk that ADSB would be unable or unwilling to make loans to its subsidiaries, second tier subsidiaries, or other affiliates; (3) ADSB faced a serious risk of failing as a going concern; (4) ADSB faced a serious risk of being placed in receivership or conservatorship by the FSLIC; (5) there was a real danger that, if ADSB were to fail or be placed in receivership or conservatorship, its affiliates, including Gateway Center, would also fail for numerous reasons; and (6) if ADSB were to fail or be placed in receivership or conservatorship, there was a significant risk that ADC Financial would lose the uninsured portion of the $4,975,000 it had in its certificate of deposit with ADSB.

(b) ADSB and its auditors were delinquent in producing audited financial statements for the year ended June 30, 1985, which delinquency was an indication of serious record-keeping, management and financial shortcomings at ADSB.

(c) ADSB was in violation of federal regulations and in violation of a regulatory agreement entered into between ADSB and CDSL on or about October 14, 1984, which restricted ADSB's aggregate direct investments, including its investments in its wholly-owned service corporations, to 60% of assets, and required it to maintain a net worth of no less than 5% of total assets, and was in violation of various other regulatory restrictions, an indication of serious management, accounting, and financial shortcomings; and that these restrictions would prohibit or restrict ADSB from further capital contributions to its subsidiaries or second tier subsidiaries that might be necessary to maintain those entities as viable concerns.

(d) ADSB was in violation of its duty to keep adequate records, indicating a serious failure in management, financial and accounting controls.

(e) The financial statements of ADC Financial contained in the PPM were false and misleading because (1) ADC Financial's net worth was dependent upon a $4,975,000 certificate of deposit with ADSB, yet the financial statements failed to disclose the problems with ADSB described above, including the material risk associated with the uninsured certificate of deposit; (2) the balance sheet contained in the financial statements for ADC Financial was outdated, (3) Arthur Young, who prepared the balance sheet, had not authorized ADC Financial to use it in connection with the Gateway Center private placement.

(f) ADC Financial had begun marketing the Hickory Trace private placement offering, pursuant to the Hickory Trace PPM, which offering was withdrawn prior to the Gateway Center sale of limited partnership units on December 31, 1985, because of the insistence of outside securities counsel that potential investors be provided with audited financial statements of ADSB for its most recent fiscal year, which statements were unavailable.

27. In light of the facts set forth in paragraph 26(a)-(f), the purchase of the Gateway Center limited partnership units involved a very high degree of risk.

28. The adverse information not disclosed by defendant was material information as to which a reasonable person would attach importance, in making the decision whether to purchase the Gateway Center limited partnership units.

29. Plaintiffs are informed and believe and thereupon allege that defendant O'Melveny & Myers, as special securities counsel and tax counsel for the Gateway Center offering, should have discovered the facts set forth in paragraph 26 above in the exercise of reasonable diligence and caused said facts to be set forth in the Gate-

way Center PPM. Instead, defendant O'Melveny & Myers failed to make any significant inquiry into the matters set forth in paragraph 26 above. Among other things, defendant O'Melveny & Myers failed to make any inquiry whatsoever with the outside public auditors for ADSB, ADCC or ADC Financial, failed to make any inquiry whatsoever with prior outside securities counsel for ADC Financial, and failed to make any inquiry whatsoever into the financial condition or regulatory status of ADSB and its service corporation subsidiaries.

30. On or about October 15, 1986, plaintiffs ADC Financial, Gateway Center and FSLIC, then Conservator of ADSB, offered to the Gateway Center Investors an opportunity to rescind their investments in Gateway Center by selling their Gateway Center limited partnership units to Gateway Center ("Gateway Center Rescission Offer"). Pursuant to the Gateway Center Rescission Offer, rescinding investors would receive, in exchange for their units, the principal amount of the consideration paid by said investor, plus interest thereon.

31. Each of the Gateway Center Investors accepted the Gateway Center Rescission Offer and transferred his or her limited partnership units to ADC Financial. As part of said rescission, each Gateway Center Investor assigned to FSLIC, as Conservator for ADSB, all rights, causes of action and claims, in connection with the Gateway Center Offering, which the investor may have against all persons involved in the Gateway Center Offering with respect to any violations of the 1933 Act, the 1934 Act and the securities laws or common laws of any state.

32. Defendant O'Melveny & Myers has entered into written agreement tolling the statute of limitations for claims arising out of the Gateway Center Offering for the period December 23, 1986 through May 15, 1989.

COUNT I

PROFESSIONAL NEGLIGENCE IN CONNECTION WITH THE WELLS PARK OFFERING

33. Plaintiffs FSLIC, ADC Financial and Wells Park incorporate by this reference the allegations set forth in paragraphs 1 through 21, inclusive.

34. In or about October, 1985, ADSB, ADC Financial and Wells Park retained defendant O'Melveny & Myers as special securities counsel and tax counsel for the Wells Park Offering.

35. As special securities counsel and special tax counsel for the Wells Park Offering, O'Melveny & Myers owed to FSLIC, ADC Financial, Wells Park, and the Wells Park Investors the duty to use such skill, prudence and diligence as other members of the legal profession commonly possess and exercise. As attorneys specializing in securities laws, O'Melveny & Myers owed to FSLIC, ADC Financial, Wells Park and the Wells Park Investors, such skill, prudence and diligence as meets the standards of knowledge and skill of securities specialists.

36. In the conduct described herein, O'Melveny & Myers failed to exercise such skill, prudence and diligence.

37. As a proximate result of the negligent conduct of O'Melveny & Myers, plaintiffs FSLIC, ADC Financial and Wells Park and the Wells Park Investors suffered damages in amounts which have not yet been ascertained.

COUNT II

PROFESSIONAL NEGLIGENCE IN CONNECTION WITH THE GATEWAY CENTER OFFERING

38. Plaintiffs FSLIC, ADC Financial and Gateway Center incorporate by this reference the allegations set

forth in paragraphs 1 through 10 and paragraphs 22 through 32, inclusive.

39. In or about October, 1985, ADSB, ADC Financial and Gateway Center retained defendant O'Melveny & Myers as special securities counsel and special tax counsel for the Gateway Center offering.

40. As special securities counsel and special tax counsel for the Gateway Center Offering, O'Melveny & Myers owed to FSLIC, ADC Financial, Gateway Center and the Gateway Center Investors the duty to use such skill, prudence and diligence as other members of the legal profession commonly possess and exercise. As attorneys specializing in securities laws, O'Melveny & Myers owed to FSLIC, ADC Financial, Gateway Center, and the Gateway Center Investors, such skill, prudence and diligence as meets the standards of knowledge and skill of securities specialists.

41. In the conduct described herein, O'Melveny & Myers failed to exercise such skill, prudence and diligence.

42. As a proximate result of the negligent conduct of O'Melveny & Myers, plaintiffs FSLIC, ADC Financial and Gateway Center and the Gateway Center Investors suffered damages in amounts which have not yet been ascertained.

COUNT III

NEGLIGENT MISREPRESENTATION IN CONNECTION WITH THE WELLS PARK OFFERING

43. Plaintiffs FSLIC, ADC Financial and Wells Park incorporate by this reference the allegations set forth in paragraphs 1 through 21, inclusive.

44. Among the direct and proximate causes of the misrepresentations and omissions to state material facts

set forth above was the negligence and carelessness of defendant O'Melveny & Myers.

45. At the time of said misrepresentations and omissions, the Wells Park Investors were ignorant of their falsity. In reliance on said representations and omissions, and in ignorance of the true facts, the Wells Park Investors were induced to and did purchase Wells Park limited partnership units. By reason thereof, the Wells Park Investors suffered damages in an amount which has not yet been ascertained, the claims pertaining to which have been assigned by the Wells Park Investors to plaintiff FSLIC.

COUNT IV

NEGLIGENT MISREPRESENTATION IN CONNECTION WITH THE GATEWAY CENTER OFFERING

46. Plaintiffs, FSLIC, ADC Financial and Gateway Center incorporate by this reference the allegations set forth in paragraphs 1 through 10, and 22 through 32, inclusive.

47. Among the direct and proximate causes of the misrepresentations and omissions to state material facts set forth above was the negligence and carelessness of defendant O'Melveny & Myers.

48. At the time of said misrepresentations and omissions, the Gateway Center Investors were ignorant of their falsity. In reliance on said representations and omissions, and in ignorance of the true facts, the Gateway Center Investors were induced to and did purchase Gateway Center limited partnership units. By reason thereof, the Gateway Center Investors suffered damages in an amount which has not yet been ascertained, the claims pertaining to which have been assigned by the Gateway Center Investors to plaintiff FSLIC.

COUNT V

BREACH OF FIDUCIARY DUTY IN CONNECTION WITH THE WELLS PARK OFFERING

49. Plaintiffs FSLIC, ADC Financial and Wells Park incorporate by this reference the allegations set forth in paragraphs 1 through 21, inclusive.

50. Defendant O'Melveny & Myers owed a fiduciary duty of due care to FSLIC, ADC Financial, Wells Park and the Wells Park Investors. Plaintiffs are informed and believe and thereupon allege that defendant violated this fiduciary duty by failing to disclose material facts in the Wells Park PPM.

51. Plaintiffs are informed and believe and thereupon allege that, as a consequence of the breach of fiduciary duty by defendant, plaintiffs FSLIC, ADC Financial and Wells Park, and the Wells Park Investors have been damaged in amounts which have not yet been ascertained.

COUNT VI

BREACH OF FIDUCIARY DUTY IN CONNECTION WITH THE GATEWAY CENTER OFFERING

52. Plaintiffs FSLIC, ADC Financial and Gateway Center incorporate by this reference the allegations set forth in paragraphs 1 through 10 and paragraphs 22 through 32, inclusive.

53. Defendant O'Melveny & Myers owed a fiduciary duty of due care to FSLIC, ADC Financial, Gateway Center and the Gateway Center Investors. Plaintiffs are informed and believe and thereupon allege that defendant violated this fiduciary duty by failing to disclose material facts in the Gateway Center PPM.

54. Plaintiffs are informed and believe and thereupon allege that, as a consequence of the breach of fiduciary duty by defendant, plaintiffs FSLIC, ADC Financial and

Gateway Center, and the Gateway Center Investors have suffered damages in amounts which have not yet been ascertained.

COUNT VII

COMPARATIVE EQUITABLE INDEMNITY AND CONTRIBUTION IN CONNECTION WITH THE WELLS PARK OFFERING

55. Plaintiffs FSLIC, ADC Financial and Wells Park incorporate by this reference the allegations set forth in paragraphs 1 through 21, inclusive.

56. Commencing in or around February, 1986, the Wells Park Investors asserted claims against plaintiffs FSLIC, ADC Financial and Wells Park in connection with their investment in the Wells Park Offering.

57. As a result of the claims by the Wells Park Investors, and in the reasonable belief that plaintiffs FSLIC, ADC Financial and Wells Park were potentially liable to those investors, plaintiffs rescinded the Wells Park Offering and repaid to the Wells Park Investors the amount of their investments, plus interest thereon, in the total amount of $1,273,164.

58. An actual controversy has arisen and now exists between plaintiffs FSLIC, ADC Financial and Wells Park, on the one hand, and defendant O'Melveny & Myers, on the other hand, in that plaintiffs contend, and defendant O'Melveny & Myers denies, the following:

(a) That as between plaintiffs and defendant O'Melveny & Myers, responsibility for the damages paid by plaintiffs to the Wells Park Investors rests entirely or partially on defendant O'Melveny & Myers; and

(b) That as a result, defendant O'Melveny & Myers is obligated to partially indemnify or fully indemnify plaintiffs for the sum of $1,273,164 paid to the Wells Park Investors in satisfaction of their

potential claims in connection with the Wells Park Offering.

59. Plaintiffs desire a judicial determination of the respective rights and duties of plaintiffs and defendant O'Melveny & Myers with respect to the damages paid by plaintiffs to the Wells Park Investors. In particular, plaintiffs desire a declaration of the respective liabilities of plaintiffs and defendant O'Melveny for those damages, and a declaration of O'Melveny & Myers' responsibility to indemnify plaintiffs for the sums it has paid to the Wells Park Investors and for which O'Melveny & Myers is determined responsible.

COUNT VIII

COMPARATIVE EQUITABLE INDEMNITY AND CONTRIBUTION IN CONNECTION WITH THE GATEWAY CENTER OFFERING

60. Plaintiffs FSLIC, ADC Financial and Gateway Center incorporate by this reference the allegations set forth in paragraphs 1 through 10 and paragraphs 22 through 32, inclusive.

61. Commencing in or around February, 1986, the Gateway Center Investors asserted claims against plaintiffs FSLIC, ADC Financial and Gateway Center in connection with their investment in the Gateway Center Offering.

62. As a result of the claims by the Gateway Center Investors, and in the reasonable belief that plaintiffs FSLIC, ADC Financial and Gateway Center were potentially liable to those investors, plaintiffs rescinded the Gateway Center Offering and repaid to the Gateway Center Investors the amount of their investments, plus interest thereon, in the total amount of $1,473,101.

63. An actual controversy has arisen and now exists between plaintiffs FSLIC, ADC Financial and Gateway Center, on the one hand, and defendant O'Melveny & Myers on the other hand, in that plaintiffs contend, and defendant O'Melveny & Myers denies, the following:

(a) That as between plaintiffs and defendant O'Melveny & Myers, responsibility for the damages paid by plaintiffs to the Gateway Center Investors rests entirely or partially on defendant O'Melveny & Myers; and

(b) That as a result, defendant O'Melveny & Myers is obligated to partially indemnify or fully indemnify plaintiffs for the sum of $1,473,101 paid to the Gateway Center Investors in satisfaction of their potential claims in connection with the Gateway Center Offering.

64. Plaintiffs desire a judicial determination of the respective rights and duties of plaintiffs and defendant O'Melveny & Myers with resptct to the damages paid by plaintiffs to the Gateway Center Investors. In particular, plaintiffs desire a declaration of the respective liabilities of plaintiffs and defendant O'Melveny for those damages and a declaration of O'Melveny & Myers' responsibility to indemnify plaintiffs for the sums it has paid to the Gateway Center Investors and for which O'Melveny & Myers is determined responsible.

WHEREFORE, plaintiffs pray for judgment against defendant O'Melveny & Myers, as follows:

1. ON COUNT I

a. That judgment be entered for plaintiffs ADC Financial, Wells Park and FSLIC in amounts according to proof at trial;

b. That plaintiffs be granted their costs of suit; and

c. For such other and further relief as the court may deem proper.

2. ON COUNT II

a. That judgment be entered for plaintiffs ADC Financial, Gateway Center and FSLIC in amounts according to proof at trial;

b. That plaintiffs be granted their costs of suit; and

c. For such other and further relief as the court may deem proper.

3. ON COUNT III

a. That judgment be entered for plaintiff FSLIC in an amount according to proof at trial;

b. That plaintiff FSLIC be granted its costs of suit; and

c. For such other and further relief as the court may deem proper.

4. ON COUNT IV

a. That judgment be entered for plaintiff FSLIC in an amount according to proof at trial;

b. That plaintiff FSLIC be granted its costs of suit; and

c. For such other and further relief as the court may deem proper.

5. ON COUNT V

a. That judgment be entered for plaintiffs ADC Financial, Wells Park and FSLIC in amounts according to proof at trial;

b. That plaintiffs be granted their costs of suit; and

c. For such other and further relief as the court may deem proper.

6. ON COUNT VI

a. That judgment be entered for plaintiffs ADC Financial, Gateway Center and FSLIC in amounts according to proof at trial;

b. That plaintiffs be granted their costs of suit; and

c. For such other and further relief as the court may deem proper.

7. ON COUNT VII

a. That judgment be entered for plaintiffs ADC Financial and Wells Park in amounts according to proof at trial;

b. That plaintiffs be granted their costs of suit; and

c. For such other and further relief as the Court may deem proper.

7. ON COUNT VIII

a. That judgment be entered for plaintiffs ADC Financial and Gateway Center in amounts according to proof at trial;

b. That plaintiffs be granted their costs of suit; and

c. For such other and further relief as the Court may deem proper.

DATED: May 12, 1989

JORDAN LUKE
JACK D. SMITH
DOROTHY L. NICHOLS
ANNE BUXTON SOBOL
CATHERINE RIBNICK
OFFICE OF THE GENERAL COUNSEL
FEDERAL HOME LOAN BANK BOARD

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SHARON L. O'GRADY

By /s/ Sharon L. O'Grady by SEF
SHARON L. O'GRADY
Attorneys for Plaintiff Federal Savings and Loan Insurance Corporation As Receiver for American Diversified Savings Bank, ADC Financial Corporation, American Diversified/Wells Park II and American Diversified/Gateway Center

JURY DEMAND

Plaintiff demands a trial by jury.

DATED: May 12, 1989

JORDAN LUKE
JACK D. SMITH
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Attorneys for Plaintiff Federal Savings and Loan Insurance Corporation As Receiver for American Diversified Savings Bank, ADC Financial Corporation, American Diversified/Wells Park II and American Diversified/Gateway Center

[Filed July 13, 1989]

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

(Title Omitted in Printing)

ANSWER AND COUNTERCLAIMS OF DEFENDANT AND COUNTERCLAIMANT O'MELVENY & MYERS TO COMPLAINT

Defendant O'Melveny & Myers ("O'Melveny") for itself alone, answers the Complaint herein by responding to the numbered paragraphs thereof and setting forth its affirmative defenses, counterclaims and prayer for relief as follows:

1. Answering Paragraph 1, O'Melveny admits that this Court has jurisdiction over the subject matter of this action.

2. Answering Paragraph 2, O'Melveny admits that venue is proper in this judicial district. O'Melveny admits that it performs legal services in Orange County, California. Except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 2.

3. Answering Paragraph 3, O'Melveny admits that the Federal Savings and Loan Insurance Corporation ("FSLIC") is a corporation organized and existing under and by virtue of the laws of the United States; that FSLIC is an instrumentality of the United States and operates under the direction of the Federal Home Loan Bank Board ("FHLBB"); and that FSLIC's conduct is governed by various statutes and regulations. Except as herein expressly admitted, O'Melveny denies each and every allegation contained in Paragraph 3.

4. Answering Paragraph 4, O'Melveny admits the allegations in Paragraph 4.

5. Answering Paragraph 5, O'Melveny admits that on or about February 14, 1986, FHLBB appointed FSLIC as conservator for ADSB, and that as such, FSLIC has certain rights and responsibilities. Except as herein expressly admitted, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 5, and for that reason denies each and every allegation therein contained.

6. Answering Paragraph 6, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 6, and for that reason denies each and every allegation therein contained.

7. Answering Paragraph 7, O'Melveny admits that sometime in June 1988, FHLBB appointed FSLIC as Receiver for ADSB, and that as such, FSLIC has certain rights and responsibilities. Except as herein expressly admitted, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 7, and for that reason denies each and every allegation therein contained.

8. Answering Paragraph 8, O'Melveny admits that American Diversified Capital Corporation ("ADCC") is and at all times relevant hereto was a wholly-owned subsidiary of ADSB. Except as herein expressly admitted, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 8, and for that reason denies each and every allegation therein contained.

9. Answering Paragraph 9, O'Melveny admits that ADC Financial Corporation ("ADCFC") is, and at all time relevant hereto, was a corporation organized and existing under the laws of the state of California with its principal place of business in Costa Mesa, California. O'Melveny admits that ADCFC is, and at all times relevant hereto, was the general partner in each of two real

estate private placements: American Diversified/Wells Park II ("Wells Park") and American Diversified/Gateway Center ("Gateway Center"). O'Melveny admits that each of Wells Park and Gateway Center is and, at all times relevant hereto, was a limited partnership organized and existing under the laws of the State of California. Except as herein expressly admitted, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 9, and for that reason denies each and every allegation therein contained.

10. Answering Paragraph 10, O'Melveny admits that it is a law partnership that has an office and does business in Orange County, California and that in 1985 it was retained by ADCFC and/or certain of its affiliates to assist in the preparation of two private placement memoranda. Except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 10.

11. Answering Paragraph 11, O'Melveny admits that as stated in the Wells Park PPM, Wells Park was intended to be involved in the ownership and operation of certain real estate. Except as herein expressly admitted, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 11, and for that reason denies each and every allegation therein contained.

12. Answering Paragraph 12, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 12, and for that reason denies each and every allegation therein contained.

13. Answering Paragragh 13, O'Melveny admits that it assisted in the preparation of the Wells Park PPM. Except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 13.

14. Answering Paragraph 14, O'Melveny alleges that the Wells Park PPM is the best evidence of its contents,

and denies all allegations inconsistent therewith; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 14.

15. Answering Paragraph 15, O'Melveny denies each and every allegation in Paragraph 15.

16. Answering Paragraph 16, O'Melveny admits that the Wells Park PPM fully disclosed the risk factors associated with the Wells Park placement; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 16.

17. Answering Paragraph 17, O'Melveny alleges that certain information about ADSB and/or its affiliates was not disclosed to O'Melveny by any of FSLIC, ADSB, ADCFC, or any of their respective affiliates; except as herein expressly alleged, O'Melveny denies each and every allegation in Paragraph 17.

18. Answering Paragraph 18, O'Melveny admits that it did not contact the law firm, Rogers & Wells, in connection with the preparation of the Wells Park PPM; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 18.

19. Answering Paragraph 19, O'Melveny admits that the "Wells Park Rescission Offer" is the best evidence of its contents, and denies all allegations inconsistent therewith; O'Melveny alleges that rescinding investors received the principal amount of their investment, plus interest, and that their claims for relief, if any, were thereby satisfied and extinguished. Except as herein expressly admitted and alleged, O'Melveny denies each and every allegation in Paragraph 19.

20. Answering Paragraph 20, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 20, and for that reason denies each and every allegation therein contained.

21. Answering Paragraph 21, O'Melveny admits that the written agreements regarding the limited waiver of unexpired statute of limitation defenses are the best evidence of their contents, and denies all allegations inconsistent therewith; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 21.

22. Answering Paragraph 22, O'Melveny admits that as stated in the Gateway Center PPM, Gateway Center was intended to be involved in the ownership and operation of certain real estate. Except as herein expressly admitted, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 22, and for that reason denies each and every allegation therein contained.

23. Answering Paragraph 23, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 23, and for that reason denies each and every allegation therein contained.

24. Answering Paragraph 24, O'Melveny admits that it assisted in the preparation of the Gateway Center PPM. Except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 24.

25. Answering Paragraph 25, O'Melveny alleges that the Gateway Center PPM is the best evidence of its contents, and denies all allegations inconsistent therewith; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 25.

26. Answering Paragraph 26, O'Melveny denies each and every allegation in Paragraph 26.

27. Answering Paragraph 27, O'Melveny admits that the Gateway Center PPM fully disclosed the risk factors associated with the Gateway Center placement; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 27.

28. Answering Paragraph 28, O'Melveny alleges that certain information about ADSB and/or its affiliates was not disclosed to O'Melveny by any of FSLIC, ADSB, ADCFC, or any of their respective affiliates; except as herein expressly alleged, O'Melveny denies each and every allegation in Paragraph 28.

29. Answering Paragraph 29, O'Melveny admits that it did not contact the law firm, Rogers & Wells, in connection with the preparation of the Gateway Center PPM; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 29.

30. Answering Paragraph 30, O'Melveny admits that the "Gateway Center Rescission Offer" is the best evidence of its contents, and denies all allegations inconsistent therewith; O'Melveny alleges that the rescinding investors received the principal amount of their investment, plus interest, and that their claims for relief, if any, were thereby satisfied and extinguished. Except as herein expressly admitted and alleged, O'Melveny denies each and every allegation in Paragraph 30.

31. Answering Paragraph 31, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 31, and for that reason denies each and every allegation therein contained.

32. Answering Paragraph 32, O'Melveny admits that the written agreements regarding the limited waiver of unexpired statute of limitation defenses are the best evidence of their contents, and denies all allegations inconsistent therewith; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 32.

ANSWER TO FIRST PURPORTED CLAIM

33. Answering Paragraph 33, O'Melveny hereby incorporates its answers to Paragraphs 1 through 21 herein.

34. Answering Paragraph 34, O'Melveny admits that in 1985, it was retained by ADCFC and/or certain of its affiliates to assist in the preparation of the Wells Park PPM. Except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 34.

35. Answering Paragraph 35, O'Melveny admits that as legal counsel assisting in the preparation of the Wells Park PPM, it owed its client a duty to use such skills, prudence and diligence as other members of the legal profession practicing in that area commonly possess and exercise; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 35.

36. Answering Paragraph 36, O'Melveny denies each and every allegation in Paragraph 36.

37. Answering Paragraph 37, O'Melveny denies each and every allegation in Paragraph 37 and specifically denies that plaintiffs have been damaged in any amount whatsoever.

ANSWER TO SECOND PURPORTED CLAIM

38. Answering Paragraph 38, O'Melveny hereby incorporates its answers to Paragraphs 1 through 10 and 22 through 32 herein.

39. O'Melveny admits that in 1985, it was retained by ADCFC and/or certain of its affiliates to assist in the preparation of the Gateway Center PPM. Except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 39.

40. Answering Paragraph 40, O'Melveny admits that as legal counsel assisting in the preparation of the Gateway Center PPM, it owed its client a duty to use such

skill, prudence and diligence as other members of the legal profession practicing in that area commonly possess and exercise; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 40.

41. Answering Paragraph 41, O'Melveny denies each and every allegation in Paragraph 41.

42. Answering Paragraph 42, O'Melveny denies each and every allegation in Paragraph 42 and specifically denies that plaintiffs have been damaged in any amount whatsoever.

ANSWER TO THIRD PURPORTED CLAIM

43. Answering Paragraph 43, O'Melveny hereby incorporates its answers to Paragraphs 1 through 21 herein.

44. Answering Paragraph 44, O'Melveny denies each and every allegation in Paragraph 44.

45. Answering Paragraph 45, O'Melveny denies each and every allegation in Paragraph 45 and specifically denies that plaintiffs have been damaged in any amount whatsoever.

ANSWER TO FOURTH PURPORTED CLAIM

46. Answering Paragraph 46, O'Melveny hereby incorporates its answers to Paragraph 1 through 10 and 22 through 32 herein.

47. Answering Paragraph 47, O'Melveny denies each and every allegation in Paragraph 47.

48. Answering Paragraph 48, O'Melveny denies each and every allegation in Paragraph 48 and specifically denies that plaintiffs have been damaged in any amount whatsoever.

ANSWER TO FIFTH PURPORTED CLAIM

49. Answering Paragraph 49, O'Melveny hereby incorporates its answers to Paragraphs 1 through 21 herein.

50. Answering Paragraph 50, O'Melveny admits that it owed its client a duty to use such skill, prudence and diligence as other members of the legal profession practicing in that area commonly possess and exercise; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 50.

51. Answering Paragraph 51, O'Melveny denies each and every allegation in Paragraph 51 and specifically denies that plaintiffs have been damaged in any amount.

ANSWER TO SIXTH PURPORTED CLAIM

52. Answering Paragraph 52, O'Melveny hereby incorporates its answers to Paragraphs 1 through 10 and 22 through 32 herein.

53. Answering Paragraph 53, O'Melveny admits that it owed its client a duty to use such skill, prudence and diligence as other members of the legal profession practicing in that area commonly possess and exercise; except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 53.

54. Answering Paragraph 54, O'Melveny denies each and every allegation in Paragraph 54 and specifically denies that plaintiffs have been damaged in any amount whatsoever.

ANSWER TO SEVENTH PURPORTED CLAIM

55. Answering Paragraph 55, O'Melveny hereby incorporates its answers to Paragraphs 1 through 21 herein.

56. Answering Paragraph 56, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 56, and for that reason denies each and every allegation therein contained.

57. Answering Paragraph 57, O'Melveny admits that plaintiffs rescinded the Wells Park Offering in the belief

that they (the plaintiffs) were potentially liable to the Wells Park Investors and, that plaintiffs returned to the Wells Park Investors the amount of their respective investments plus interest thereon. Except as herein expressly admitted, O'Melveny denies each and every allegation in Paragraph 57.

58. Answering Paragraph 58, O'Melveny alleges that plaintiffs' return to the Wells Park Investors fully satisfied and extinguished the Wells Park Investors' claims, if any; and O'Melveny denies that plaintiffs were damaged in any amount whatsoever. Except as herein expressly alleged and denied, O'Melveny admits each and every other allegation in Paragraph 58.

59. Answering Paragraph 59, O'Melveny denies that O'Melveny is responsible for plaintiffs' damages, if any; that O'Melveny is responsible to partially or fully indemnify plaintiffs for the amounts returned to the Wells Park Investors, or that plaintiffs are entitled to any relief whatsoever. Except as herein expressly denied, O'Melveny admits each and every other allegation in Paragraph 59.

ANSWER TO EIGHTH PURPORTED CLAIM

60. Answering Paragraph 60, O'Melveny hereby incorporates its answers to Paragraphs 1 through 10 and 22 through 32 herein.

61. Answering Paragraph 61, O'Melveny is without knowledge or information sufficient to form a belief as to the truth of the allegations in Paragraph 61, and for that reason denies each and every allegation therein contained.

62. Answering Paragraph 62, O'Melveny admits that plaintiffs rescinded the Gateway Center Offering in the belief that they (the plaintiffs) were potentially liable to the Gateway Center Investors and, that plaintiffs returned to the Gateway Center Investors the amount of their

respective investments plus interest thereon. Except as herein expressly admitted, O'Melveny denies each and very allegation in Paragraph 62.

63. Answering Paragraph 63, O'Melveny alleges that plaintiffs' return to the Gateway Center Investors fully satisfied and extinguished the Gateway Center Investors' claims, if any, and O'Melveny denies that plaintiffs were damaged in any amount whatsoever. Except as herein expressly denied and alleged, O'Melveny admits each and every other allegation in Paragraph 63.

64. Answering Paragraph 64, O'Melveny denies that O'Melveny is responsible for plaintiffs' damages, if any; that O'Melveny is responsible to partially or fully indemnify plaintiffs for the amounts returned to the Gateway Center Investors; or that plaintiffs are entitled to any relief whatsoever. Except as herein expressly denied, O'Melveny admits each and every other allegation in Paragraph 64.

FIRST AFFIRMATIVE DEFENSE

65. The Complaint fails to state any claim upon which relief can be granted, either in law or equity.

SECOND AFFIRMATIVE DEFENSE

66. Plaintiffs did not suffer any damage and any damages alleged are attributable to causes other than any asserted acts or omissions of O'Melveny.

THIRD AFFIRMATIVE DEFENSE

67. Plaintiffs are barred from bringing claims on behalf of investors in the Wells Park II and Gateway Center limited partnerships because said investors were made whole when the transactions were rescinded and therefore had no claims to assign. Since said investors' purported claims have been fully satisfied and are extinguished, they cannot be asserted by FSLIC or any other person.

FOURTH AFFIRMATIVE DEFENSE

68. The intentional wrongdoing of the officers and directors of ADSB and/or certain of its affiliates, including among other things, their fraud, mismanagement of ADSB, and misrepresentations about ADSB's financial and regulatory condition, is imputed to ADSB and/or certain of its affiliates. Such intentional wrongdoing bars plantiffs from maintaining any claims for relief against O'Melveny.

FIFTH AFFIRMATIVE DEFENSE

69. Plaintiffs were aware of or had actual knowledge of the information that O'Melveny purportedly should have uncovered, and plaintiffs negligently or intentionally failed to disclose said information to O'Melveny. Accordingly, plaintiffs are liable to O'Melveny for contribution or are required to indemnify O'Melveny.

SIXTH AFFIRMATIVE DEFENSE

70. Plaintiffs are estopped from asserting any claims for relief against O'Melveny because they were aware or reasonably should have been aware of the information that O'Melveny allegedly should have discovered, and they negligently or intentionally failed to disclose said information to O'Melveny.

SEVENTH AFFIRMATIVE DEFENSE

71. Plaintiffs' own criminal or intentionally tortious conduct, not O'Melveny's alleged negligence, if any, was the cause of plaintiffs' alleged damage.

EIGHTH AFFIRMATIVE DEFENSE

72. Plaintiffs' Complaint is uncertain in that it seems to allege that ADSB and its affiliates are separate and distinct from the persons who own and manage them, and that O'Melveny can be liable to the corporate entity

notwithstanding the misleading, fraudulent and wrongful conduct engaged in by the entity's owners and managers. O'Melveny denies this formulation by plaintiffs; however, if there is a distinction between the owners and management and the corporate entity itself, FSLIC owes a duty to the corporate entity to inform said entity in an effective manner of its orders, requirements and regulations. In order to communicate in an effective manner, FSLIC, because it knew or reasonably should have known of the improprieties, misconduct and fraud of the owners and managers of ADSB and its affiliates had a non-discretionary duty to advise persons who would protect the corporate entity of said orders, requirements and regulations. Accordingly, FSLIC had a duty either to inform O'Melveny of its orders, requirements, and regulations or to require the owners and management of ADSB and its affiliates to so inform O'Melveny. This duty FSLIC negligently violated.

NINTH AFFIRMATIVE DEFENSE

73. Plaintiffs are barred from maintaining any claims for relief against O'Melveny because O'Melveny owed no duty to them to uncover their own fraud, wrongdoing or misconduct.

TENTH AFFIRMATIVE DEFENSE

74. Plaintiffs are barred from maintaining any claims for relief against O'Melveny because O'Melveny's purported negligence, negligent misrepresentation, or breach of fiduciary duty, if any, was not the proximate cause of plaintiffs' alleged damage, if any.

ELEVENTH AFFIRMATIVE DEFENSE

75. O'Melveny owed no duty to any of: the Wells Park II limited partnership, the Gateway Center limited partnership, the investors in Wells Park II, or the investors in Gateway Center, and therefore such persons or

entities are barred from asserting any claims for relief against O'Melveny.

TWELFTH AFFIRMATIVE DEFENSE

76. The Gateway Center investors and Wells Park II investors did not rely on the Gateway Center and Wells Park II PPMs in making their investment decisions, and therefore such investors cannot state any claims for relief against O'Melveny.

THIRTEENTH AFFIRMATIVE DEFENSE

77. Plaintiffs' Complaint is uncertain it [sic] that it seems to allege that FSLIC is not merely the successor in interest to ADSB, and as such, entitled to assert ADSB's claims, if any, but also that it has the right to assert claims in its own right that ADSB could not assert. O'Melveny denies this formulation by plaintiffs; however, if there is such a distinction, FSLIC is barred from asserting any claims in its own right against O'Melveny because it knew or reasonably should have known the information O'Melveny purportedly should have uncovered, and thus FSLIC itself, not O'Melveny caused its own purported damage, if any.

FOURTEENTH AFFIRMATIVE DEFENSE

78. The claims asserted in the Complaint herein are barred by reason of laches.

FIFTEENTH AFFIRMATIVE DEFENSE

79. Plaintiffs have waived each and every purported claim in their Complaint.

SIXTEENTH AFFIRMATIVE DEFENSE

80. Plaintiffs' purported claims for relief are barred in whole or in part by the applicable statutes of limitations.

SEVENTEENTH AFFIRMATIVE DEFENSE

81. Plaintiffs' purported claims for relief are barred by the Statute of Frauds, Section 1974 of the California Code of Civil Procedure.

EIGHTEENTH AFFIRMATIVE DEFENSE

82. Plaintiffs' purported claims for relief and each of them are barred by plaintiffs' unclean hands in that plaintiffs knew or reasonably should have known all of the purported facts and information that O'Melveny allegedly was to uncover, and concealed or failed to disclose such purported facts and information from O'Melveny.

NINETEENTH AFFIRMATIVE DEFENSE

83. O'Melveny relied to its detriment on the actions of plaintiffs and plaintiffs are thereby estopped from asserting any of the claims contained in the Complaint.

COUNTERCLAIMS

Counterclaimant O'Melveny & Myers ("O'Melveny") alleges as follows:

JURISDICTION AND VENUE

1. This Court has ancillary jurisdiction over these counterclaims in that the claims contained herein are compulsory counterclaims to the purported claims in the Complaint. The amount in controversy exceeds the jurisdictional amount of this Court. Venue is proper in this Court pursuant to 28 U.S.C. § 1391 in that the counterclaims arose in this district and counterclaimant resides in the Central District of California.

PARTIES

2. Counterclaimant O'Melveny & Myers ("O'Melveny") is, and at all times relevant hereto, was a partnership engaged in the practice of law, having its principal

place of business in Los Angeles, California. O'Melveny has filed and published a fictitious business name statement as required by Sections 17910 through 17917 of California Business and Professions Code.

3. O'Melveny is informed and believes and thereon alleges that counterdefendant Federal Savings and Loan Insurance Corporation ("FSLIC") is, and at all times relevant hereto, was a corporation organized and existing under and by virtue of the laws of the United States. O'Melveny is informed and believes and thereon alleges that FSLIC is an instrumentality of the United States and operates under the direction of the Federal Home Loan Bank Board ("FHLBB").

4. O'Melveny is informed and believes and thereon alleges that American Diversified Savings Bank ("ADSB") is, and at all times relevant hereto, was a savings and loan association chartered under the laws of the State of California, whose deposits are insured by FSLIC. O'Melveny is informed and believes and thereon alleges that ADSB has and at all times relevant hereto has had its principal place of business in Costa Mesa, California. O'Melveny is informed and believes and thereon alleges that on or about February 14, 1986, FHLBB appointed FSLIC as Conservator for ADSB and that on or about June 6, 1988, FHLBB appointed FSLIC as Receiver for ADSB.

5. O'Melveny is informed and believes and thereon alleges that counterdefendant ADC Financial Corporation ("ADCFC") is, and at all times relevant hereto, was a corporation organized and existing under the laws of the State of California with its principal place of business in Costa Mesa, California. O'Melveny is informed and believes and thereon alleges that ADCFC is wholly owned by American Diversified Capital Corporation ("ADCC"), a corporation which, in turn, is wholly owned by ADSB. O'Melveny is informed and believes and thereon alleges that ADCFC is, and at all times relevant

hereto, was the general partner in each of two real estate private placements: American Diversified/Wells Park II ("Wells Park") and American Diversified/Gateway Center ("Gateway Center"). O'Melveny is informed and believes and thereon alleges that each of Wells Park and Gateway Center is and, at all times relevant hereto, was a limited partnership organized and existing under the laws of the State of California.

FIRST COUNTERCLAIM

(Breach of Contract)

6. O'Melveny repeats and incorporates herein by this reference as though set forth in full each and every allegation of Paragraphs 1 through 5, inclusive.

7. On or about September 1985, O'Melveny and ADCFC and/or certain of its affiliates entered into an oral agreement (the "Agreement") whereby O'Melveny agreed to assist ADCFC and/or certain of its affiliates in connection with the preparation of private placement memoranda ("PPMs") for real estate limited partnership offerings including Wells Park and Gateway Center, to render tax opinions for the placements, and to perform such other legal services as ADCFC or certain of its affiliates might, from time to time, require and to which O'Melveny might agree. ADSB and/or certain of its affiliates agreed to compensate O'Melveny for all legal services rendered on its behalf or on behalf of any of said affiliates, including ADCFC, and to reimburse O'Melveny for costs incurred on its behalf or on behalf of said affiliates, in amounts to be specified in periodic statements from O'Melveny.

8. Pursuant to the Agreement, O'Melveny diligently represented ADCFC and/or certain of its affiliates in connection with, among other things, preparation of private placement memoranda and tax opinions.

9. O'Melveny has performed all acts, services and conditions precedent required of it under the Agreement.

10. The value of the services, costs, and expenses herein alleged, as specified in statements to ADSB by O'Melveny is $38,965.08.

11. O'Melveny has made demand on ADSB and/or certain of its affiliates, and FSLIC, as Receiver for ADSB, for payment of compensation for legal services rendered and for reimbursement of cost and expenses (other than those amounts already paid) in the total sum of $38,-965.08.

12. ADSB and/or certain of its affiliates, and FSLIC, as Receiver for ADSB, breached and continue to breach the Agreement by failing to make payment to O'Melveny of the amount owed for legal services rendered by O'Melveny and for costs and expenses incurred by O'Melveny on behalf of ADCFC and/or certain of its affiliates. The amount of $38,965.08 remains due, owing and unpaid for legal services rendered and for reimbursement of costs and expenses.

13. As a result of the foregoing breach of the Agreement, O'Melveny has been damaged in the total amount of $38,965.08.

SECOND COUNTERCLAIM

(Account Stated)

14. O'Melveny repeats and incorporates herein by this reference as though set forth in full each and every allegation of Paragraphs 1 through 13, inclusive.

15. Between September, 1985, and March, 1986, O'Melveny performed services for counterdefendants as their attorney in various legal matters, and advanced and paid out sums of money for the account and benefit of counterdefendants, all at counterdefendants' instance and request.

16. Within four years last past, at Newport Beach, California, an account was stated in writing by and between O'Melveny and ADSB and/or certain of its affil-

iates wherein it was agreed that ADSB and/or certain of its affiliates were indebted to O'Melveny in the sum of $38,965.08.

17. No part of said sum has been paid, although demand therefor has been made, and there is now due, owing and unpaid the sum of $38,965.08, together with interest thereon at the maximum allowable rate of interest per year.

WHEREFORE, defendant and counterclaimant O'Melveny & Myers prays as follows:

A. That the Complaint be dismissed;

B. That plaintiffs take nothing in this action;

C. That in the event declaratory relief is granted, the Court declare the rights and duties of the parties to be as O'Melveny contends rather than as plaintiffs contend;

D. That judgment in favor of O'Melveny & Myers be entered on its Counterclaims in the sum of $38,965.08 plus interest at the maximum allowable rate of interest per year;

E. That O'Melveny & Myers have judgment for its costs of suit and its attorneys' fees; and

F. For such other and further relief as the Court may deem just and proper.

DATED: July 12, 1989.

IRELL & MANELLA
GREGORY R. SMITH
SARA D. LIPSCOMB

By: /s/ Sara D. Lipscomb
SARA D. LIPSCOMB
Attorneys for Defendant
and Counterclaimant
O'Melveny & Myers

(Proof of Service Omitted in Printing)

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

(Title Omitted in Printing)

ANSWER OF COUNTERDEFENDANTS FSLIC AS RECEIVER FOR ADSB, ET AL., TO COUNTERCLAIMS OF O'MELVENY AND MYERS

JURY TRIAL DEMANDED

Counterdefendants Federal Savings and Loan Insurance Corporation as Receiver for American Diversified Savings Bank (hereinafter "FSLIC as Receiver for ADSB"), ADC Financial Corporation (hereinafter "ADC Financial"), American Diversified/Wells Park II (hereinafter "Wells Park"), and American Diversified/Gateway Center (hereinafter "Gateway Center") and Federal Savings and Loan Insurance Corporation ("FSLIC") (hereinafter all collectively referred to as "Counterdefendants") answer the counterclaims of O'Melveny & Myers ("O'Melveny") (hereinafter the "Counterclaim") as follows:

FIRST AFFIRMATIVE DEFENSE

1. Answering the allegations of paragraph 1 of the Counterclaim, Counterdefendants admit that the claims contained in the Counterclaim purport to be compulsory counterclaims; that O'Melveny purports to invoke the jurisdiction of this Court under the principles alleged; that the counterclaims purportedly arose in this district; that O'Melveny resides in this district; and that O'Melveny purports to invoke the venue of this court under the statutes and principles alleged. Except as expressly admitted, Counterdefendants deny each and every allegation of paragraph 1 of the Counterclaim.

2. Answering the allegations of paragraph 2 of the Counterclaim, Counterdefendants admit that O'Melveny & Myers is, and, at all relevant times, was a partnership engaged in the practice of law, and that O'Melveny purports to have its principal place of business in Los Angeles, California. Except as expressly admitted, Counterdefendants lack sufficient knowledge or information to form a belief as to truth of the rest of the allegations, and on that basis deny each and every allegation contained in paragraph 2 of the Counterclaim.

3. Answering the allegations of paragraph 3 of the Counterclaim, Counterdefendants admit that counterdefendant FSLIC is, and, at all relevant times, was a corporation organized and existing under and by virtue of the laws of the United States; that FSLIC is an instrumentality of the United States and that FSLIC operates under the direction of the Federal Home Loan Bank Board ("FHLBB").

4. Answering the allegations of paragraph 4 of the Counterclaim, Counterdefendants admit that ADSB was a savings and loan association chartered under the laws of the State of California; that certain of ADSB's deposits were insured by FSLIC; that, at all relevant times, ADSB had its principal place of business in Costa Mesa, California; that on or about February 14, 1986, the FHLBB appointed FSLIC as Conservator of ADSB; and that on or about June 3, 1988, the FHLBB appointed FSLIC as Receiver for ADSB. Except as expressly admitted, Counterdefendants deny each and every allegation contained in paragragh 4 of the Counterclaim.

5. Answering the allegations of paragraph 5 of the Counterclaim, Counterdefendants admit that ADC Financial is, and at all relevant times, was a corporation organized and existing under the laws of the State of California; that at all relevant times, its principal place of business was in Costa Mesa, California; that ADC Financial is wholly owned by American Diversified Capital

Corporation ("ADCC"); that ADCC is wholly owned by ADSB; that ADC Financial is, and, at all relevant times, was the general partner in Wells Park and Gateway Center; that limited partnership units in Wells Park and Gateway Center were offered for sale to investors pursuant to private placement memoranda; and that Wells Park and Gateway Center are, and at all relevant times, were limited partnerships organized and existing under the laws of the State of California. Except as expressly admitted, Counterdefendants deny each and every allegation contained in paragraph 5 of the Counterclaim.

FIRST COUNTERCLAIM

(Breach of Contract)

6. Answering paragraph 6 of the Counterclaim, Counterdefendants hereby incorporate by reference their answers to each of the allegations of paragraphs 1 through 5, inclusive.

7. Answering paragraph 7 of the Counterclaim, Counterdefendants admit that O'Melveny was retained by ADSB, ADC Financial, Wells Park and Gateway Center as special securities counsel and tax counsel with respect to the offerings to potential investors of limited partnership units in Wells Park and Gateway Center. Except as expressly admitted, Counterdefendants lack sufficient knowledge or information to form a belief as to truth of the rest of the allegations insofar as they were part of the terms of any purported oral agreement between O'Melveny and any ADSB entity or affiliate, and on that basis deny each and every allegation contained in paragraph 7 of the Counterclaim.

8. Answering paragraph 8 of the Counterclaim, Counterdefendants deny each and every allegation contained in paragraph 8 of the Counterclaim.

9. Answering paragraph 9 of the Counterclaim, Counterdefendants deny each and every allegation contained in paragraph 9 of the Counterclaim.

10. Answering paragraph 10 of the Counterclaim, Counterdefendants deny each and every allegation contained in paragraph 10 of the Counterclaim.

11. Answering paragraph 11 of the Counterclaim, Counterdefendants deny that O'Melveny made a demand in the normal course of business on FSLIC as Receiver for ADSB for payment of alleged compensation for legal services rendered and for reimbursement of alleged cost [sic] and expenses (other than those amounts already paid) in the alleged total sum of $38,965.08. Counterdefendants admit that certain correspondence was received from O'Melveny pertaining to sums allegedly owed to O'Melveny and aver that the documents speak for themselves. Except as expressly admitted, Counterdefendants lack sufficient knowledge or information to form a belief as to truth of the rest of the allegations, and on that basis deny each and every allegation contained in paragraph 11 of the Counterclaim.

12. Answering paragraph 12 of the Counterclaim, Counterdefendants deny each and every allegation contained in paragraph 12 of the Counterclaim.

13. Answering paragraph 13 of the Counterclaim, Counterdefendants deny each and every allegation contained in paragraph 13 of the Counterclaim.

SECOND COUNTERCLAIM

(Account Stated)

14. Answering paragraph 14 of the Counterclaim, Counterdefendants hereby incorporate by reference their answers to each of the allegations of paragraphs 1 through 13, inclusive.

15. Answering paragraph 15 of the Counterclaim, Counterdefendants admit that between September, 1985, and March, 1986, O'Melveny performed services for Counterdefendants as their attorney in various legal matters. Except as expressly admitted, Counterdefendants deny each and every allegation contained in paragraph 15 of the Counterclaim.

16. Answering paragraph 16 of the Counterclaim, Counterdefendants deny each and every allegation contained in paragraph 16 of the Counterclaim.

17. Answering paragraph 17 of the Counterclaim, Counterdefendants admit that no part of the alleged sum of $38,965.08 has been paid. Except as expressly admitted, Counterdefendants lack sufficient knowledge or information to form a belief as to truth of the rest of the allegations, and on that basis deny each and every allegation contained in paragraph 17 of the Counterclaim.

SECOND AFFIRMATIVE DEFENSE

Counterdefendants allege that the Counterclaim, and each cause of action contained therein, fail to state a claim against Counterdefendants upon which relief can be granted.

THIRD AFFIRMATIVE DEFENSE

O'Melveny is barred from recovery against Counterdefendants under the equitable doctrine of unclean hands.

FOURTH AFFIRMATIVE DEFENSE

O'Melveny, as a result of its professional negligence in connection with the legal services it performed for Counterdefendants, is estopped from asserting claims, actions, demands or causes of actions against Counterdefendant.

FIFTH AFFIRMATIVE DEFENSE

O'Melveny is barred from recovery against Counterdefendants under the doctrine of laches in that O'Melveny delayed an unreasonable period of time in bringing this action, to the prejudice of Counterdefendants.

SIXTH AFFIRMATIVE DEFENSE

O'Melveny, by virtue of the history of the attorney-client relationship between O'Melveny and Counterdefendants, and the trust placed in O'Melveny by Counterdefendants, owed Counterdefendants fiduciary duties which it has breached as a result of its conduct in performing legal services for Counterdefendants. O'Melveny's breach of its fiduciary duties to Counterdefendants excuses and discharges Counterdefendants, and each of them, from further obligations, if any, to O'Melveny.

SEVENTH AFFIRMATIVE DEFENSE

O'Melveny has waived each and every purported claim in its Counterclaim.

EIGHTH AFFIRMATIVE DEFENSE

O'Melveny's purported claims for relief are barred in whole or in part by the applicable statutes of limitations.

NINTH AFFIRMATIVE DEFENSE

O'Melveny's purported claims for relief are barred by the Statute of Frauds, Section 1624(a) of the California Civil Code.

TENTH AFFIRMATIVE DEFENSE

The injury or injuries alleged in the Counterclaim, if any, was or were proximately caused by O'Melveny's failure to act in a reasonable and prudent manner.

WHEREFORE, Counterdefendants pray for judgment against O'Melveny as follows:

1. That the Court dismiss the Counterclaim on its merits and with prejudice as to O'Melveny & Myers;

2. That O'Melveny & Myers be adjudged to take nothing by reason of the Counterclaim;

3. That in the event declaratory relief is granted, the Court declare the rights and duties of the parties to be as Counterdefendants contend rather than as O'Melveny & Myers contends;

4. That judgment be awarded in favor of the Counterdefendants against O'Melveny & Myers;

5. That Counterdefendants be awarded their costs of suit incurred herein; and

6. That this Court award such other and further relief as this Court deems just and proper.

DATED: August 5, 1989

PETTIT & MARTIN
THEODORE RUSSELL
WILLIAM R. HARMSEN
SHARON L. O'GRADY
JUDITH L. ANDERSON

By: /s/ Judith L. Anderson
JUDITH L. ANDERSON
Attorneys for Plaintiffs and Counterdefendants Federal Savings and Loan Insurance Corporation as Receiver for American Diversified Savings Bank, et al.

Of Counsel:
JORDAN LUKE
JACK D. SMITH
DOROTHY L. NICHOLS
CATHERINE RIBNICK

JURY DEMAND

Counterdefendants demand a trial by jury on the counterclaims asserted by O'Melveny & Myers.

DATED: August 5, 1989

PETTIT & MARTIN
THEODORE RUSSELL
WILLIAM R. HARMSEN
SHARON L. O'GRADY
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By: /s/ Judith L. Anderson
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Of Counsel:
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(Proof of Service by Mail Omitted in Printing)

No. 93-489 (11)

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

O'MELVENY & MYERS,
a Law Partnership,
Petitioner,
v.

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS PARK II, and AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF FOR PETITIONER

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January 13, 1994

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

102pp

QUESTIONS PRESENTED

1. Whether 12 U.S.C. § 1821(d)(2)(A)(i), which provides that the Federal Deposit Insurance Corporation (FDIC) as receiver succeeds to the rights of a failed savings and loan, precludes judicial promulgation of a uniform federal rule of decision that eliminates requirements under applicable state law for a valid claim by the savings and loan against a former outside attorney.

2. Whether under *United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715 (1979), it is proper to create a uniform federal rule of decision to determine the defenses to a state-law tort claim brought by a receiver for a savings and loan against a former outside attorney to the savings and loan.

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BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-16a) is reported at 969 F.2d 744. The decision of the United States District Court for the Central District of California (Pet. App. 18a-19a) is not reported.

JURISDICTION

The court of appeals issued its decision on June 29, 1992. A timely petition for rehearing was denied on June 30, 1993. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

12 U.S.C. § 1821(d)(2)(A)(i):

> Powers and duties of Corporation as conservator or receiver. (2) General powers. (A) Successor to institution. The Corporation shall, as conservator or receiver, and by operation of law, succeed to—
>
> > (i) all rights, titles, powers, and privileges of the insured depository institution, and of any stockholder, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution.

STATEMENT OF THE CASE

This case presents for review the unprecedented ruling of the Ninth Circuit that, when the FDIC as receiver for a failed savings and loan sues a lawyer for alleged malpractice, the lawyer may not base a defense on the knowledge and wrongdoing of the client's owners and controlling officers and directors, or even of the client itself. Petitioner, the law firm of O'Melveny & Myers, provided legal services to American Diversified Savings Bank (ADSB) between late September and December 1985.[1]

[1] This statement is based on a set of facts to which the petitioner stipulated solely to test the legal validity of the FDIC's tort claims. The stipulation was prepared prior to any formal discovery by

During this three-month period, petitioner assisted in the preparation of two "Private Placement Memoranda" (PPMs) that ADSB used in soliciting investments in real estate syndications. Less than two months after these transactions closed, the Federal Home Loan Bank Board (FHLBB) declared ADSB insolvent and appointed the Federal Savings and Loan Insurance Corporation (FSLIC) conservator and later receiver for the thrift. Thereafter, the FSLIC caused ADSB and its subsidiaries to rescind the offerings and to return to the investors all sums invested, plus interest, in return for recovery of the syndicated real estate. Over two years later, the FSLIC brought this action to recover the out-of-pocket expenses of ADSB and its subsidiaries incurred in connection with the two transactions. Pet. App. 15a.[2]

At the time ADSB retained petitioner, ADSB's principal officers and directors and sole shareholders were engaged in an extensive campaign of fraud to hide the thrift's insolvency and to avoid take-over by federal and state regulators. Stip. ¶ 71. This campaign was orchestrated by Ranbir Sahni, ADSB's Chairman and Chief Executive Officer, and Lester Day, ADSB's President. As owners of, respectively, 96% and 4% of ADSB's stock, Sahni and Day completely controlled and dominated the institution.[3]

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petitioner. Petitioner would contest many of the facts included in the stipulation at the behest of the FDIC in the event of further proceedings. Citations are to the Stipulation ("Stip. ¶") and attached exhibits, which appear in the Excerpts of Record ("E.R.").

[2] Following passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183, the FDIC assumed FSLIC's responsibilities and was substituted as a party to this action.

[3] In a related proceeding, the FDIC explained that

> Sahni and Day were in complete control of the day-to-day operations of ADSB and its subsidiaries. They appointed all of the corporate officers. Sahni initiated almost all commercial loans, and only Sahni and Day could approve such loans. Day had to sign off on all real estate deals. . . .

Together with ADSB's Executive Vice President, Wyn Pope, Sahni and Day "intentionally and fraudulently overvalued ADSB's assets, engaged in sham sales of assets in order to create inflated 'profits,' and generally 'cook[ed] the books.'" Pet. App. 3a.

To facilitate this deceit, Sahni and Day also fired or replaced ADSB's accountants and lawyers when, after many months, those professionals began to learn of the institution's true financial condition. The successor firms (such as petitioner) were told that their predecessors had been too expensive for further work. Sahni and Day also concealed from the dismissed or outgoing firms the fact that ADSB was proceeding with new real estate transactions prepared by new accountants or lawyers. Petitioner was the last firm unwittingly drawn into this scheme, which ended less than five months after petitioner was retained, when federal regulators closed ADSB.

1. The Growth Of ADSB

Ranbir Sahni purchased Tokay Savings and Loan Association, a small California-chartered thrift, in June 1983 and, after renaming it, rapidly transformed the institution. Within two years, ADSB ranked 230th nationally among thrifts in deposits and 257th in assets. Stip. ¶ 98. ADSB's principal activity under Sahni's control was the purchase, development and sale of real estate through limited partnerships sponsored by its wholly owned subsidiaries. Pet. App. 2a.

Growth such as ADSB's was common during the mid-1980s, and indeed was encouraged by federal legislation enacted earlier in the decade. With the high interest rates of the late 1970s and early 1980s, thrifts had been increasingly unable to compete for funds due to regulatory limits on the interest they could pay on deposits. See H.R.

> In short, every important decision made on behalf of ADSB or its subsidiaries had to be known and approved by either Sahni or Day.

Brief for Appellants at 8-9, *California Unions Ins. Co.* v. *American Diversified Sav. Bank*, 948 F.2d 556 (9th Cir. 1991) (No. 89-55843).

Rep. No. 54(I), 101st Cong., 1st Sess. 294-97 (1989). Congress responded by passing the Depository Institutions Deregulation and Monetary Control Act of 1980, which phased out interest rate caps on deposits, raised deposit insurance coverage from $40,000 to $100,000, and authorized thrifts to offer Negotiable Order of Withdrawal, or NOW, accounts. *Id.* at 295.

Although these changes enabled thrifts to attract depositors, they were forced to pay higher rates on deposits than they were collecting on their traditional long-term, low-yielding mortgage loans. *Id.* at 296. By 1982, this "interest squeeze" had caused more than 300 depository institutions to fail. *Id.* Congress addressed this problem in the Garn-St Germain Depository Institutions Act of 1982, which "gave thrifts far greater flexibility in deciding how their money could be invested." *Id.* at 297. ADSB was one of the "hundreds" of thrifts that "wasted little time in taking advantage of the expanded opportunities, capabilities, and incentives" that the new law provided. L. White, *The S&L Debacle* 99 (1991). Indeed, ADSB's investments were typical of a trend that led to a tripling of the "nontraditional" assets held by thrifts between 1982 and 1985. *Id.* at 102.

2. ADSB's Difficulties With State And Federal Regulators

State and federal regulators first uncovered irregularities at ADSB during a routine examination begun in late 1983, approximately six months after Sahni acquired the savings and loan. Stip. ¶ 37; E.R. 2628. In the course of a joint examination, FHLBB examiners and the California Department of Savings and Loan discovered that ADSB had loaned $82.7 million in excess of certain state lending limits (E.R. 1691), had failed to submit required financial reports on a timely basis, and was guilty of "pervasive accounting deficiencies [that] could be an indication of unsafe and unsound practices." E.R. 1692.

On June 20, 1984, the FHLBB and ADSB executed a Supervisory Agreement. This Agreement, which was not a public document, required, among other things, that the thrift limit its loans to any one borrower, dispose of all loans in excess of these limitations, and maintain accurate and complete records. Stip. ¶ 40; E.R. 186-89. On October 4, 1984, state regulators and ADSB executed a consent order, also not publicly available, that required ADSB to maintain a net worth of at least 5% of its total assets, and to limit investments in subsidiary service corporations to 60% of its total assets. Stip. ¶ 44; E.R. 216.

Regulators soon learned, however, that ADSB was continuing to violate its regulatory obligations. In a confidential letter dated January 18, 1985, the FHLBB noted that the thrift's "sizable loans" to subsidiaries were "in direct violation" of the limitation on loans to one borrower. E.R. 246. The FHLBB also expressed alarm about ADSB's investment and lending practices, which it found "clearly expose[d] the institution to significant interest-rate and funding risks" and could result in "material adverse effects on its financial condition." E.R. 243. Noting "numerous regulatory violations" that examiners had observed, the FHLBB sought assurances from the thrift's auditors, Touche Ross, that ADSB was complying with the accounting requirements of the Supervisory Agreement and applicable regulations. E.R. 245, 247.

These assurances, however, were not forthcoming. Instead, in April 1985, Touche Ross advised ADSB that it had improperly recognized income tax benefits of nearly $6 million and had improperly deferred recognition of financial futures losses of nearly $19 million, and that proper accounting and adjustments to reflect these and other losses would reduce the thrift's net worth to less than zero. Stip. ¶¶ 59-60; E.R. 302.

ADSB responded by discharging Touche Ross in late April and replacing it with Arthur Young. Stip. ¶ 65. ADSB explained the change on the ground that Touche Ross was too expensive. Stip. ¶ 66. In addition, the thrift's Vice President of Finance, James Miller, assured Arthur Young that weaknesses Touche Ross had identified in ADSB's accounting controls had been "substantially corrected" and that "the accounting records of [ADSB]

and its subsidiaries can be relied upon." E.R. 295. Although one month earlier Miller had advised Sahni, Day, and Pope that the thrift was violating its subsidiary investment limitation and net worth requirement, had suffered large losses, and would probably have to make "[l]arge audit adjustments" (Stip. ¶ 55), he did not apprise Arthur Young of these problems. E.R. 295-96.

Touche Ross responded to its dismissal by writing a series of letters, dated May 3, 1985, to state and federal regulators, Sahni, and ADSB's outside counsel, Rogers & Wells, detailing regulatory violations in ADSB's accounting practices and stating that ADSB was, in all probability, insolvent. In its letter to the FHLBB, with copies to state regulators, Rogers & Wells, and Sahni, Touche Ross stated that "the current trend of operations . . . threaten[s] the continued viability of the [bank]," and that, properly calculated to reflect unrecognized losses, ADSB's net worth was "reduced to below zero." E.R. 302. The firm reiterated its concerns and conclusions in separate letters to Sahni and Rogers & Wells, with copies to state regulators and the FHLBB.[4]

Despite these warnings, regulators did not close the thrift. Instead, in a confidential letter dated May 29, 1985, the FHLBB advised ADSB that it viewed the thrift's real estate investments as "unsafe and unsound" and directed it "to cease all such investment immediately." E.R. 982. The FHLBB also commenced new appraisals of ADSB's real estate holdings. Stip. ¶ 57.

3. The Private Placement Memoranda Prepared By Rogers & Wells

During 1985, ADSB issued four PPMs to real estate investors. Rogers & Wells assisted in the preparation of the first two; petitioner, the latter two.

[4] Touche Ross's letter to Sahni noted that the bank "has a deficiency in assets" that threatened its "continuing viability." E.R. 303. It recommended that ADSB consult with legal counsel concerning how to disclose these facts "to all pertinent parties," and forwarded a copy of the letter directly to Rogers & Wells. E.R. 304.

The first of these PPMs, which ADSB issued in connection with its Vineyard Way syndication, was in circulation at the time ADSB fired Touche Ross. On May 3, 1985, Touche Ross advised Rogers & Wells and Sahni that it was withdrawing its financial reports from the Vineyard Way PPM. E.R. 980. Touche Ross explained its belief that, although a wholly owned subsidiary, rather than ADSB, was serving as the general partner for this syndication, the syndication ultimately depended on the thrift for operating funds. *Id.* Accordingly, Touche Ross concluded that ADSB's "significantly deteriorating condition" prevented the firm from providing an unqualified opinion for the Vineyard Way PPM. *Id.* Touche Ross further stated that, in its view, the Vineyard Way PPM should disclose ADSB's current financial conditions. *Id.*

Notwithstanding Touche Ross's views, Rogers & Wells' revisions to the Vineyard Way PPM contained no disclosure concerning ADSB. Instead, the revised PPM issued on May 10, 1985, contained a financial statement dated March 31, 1985, that Arthur Young had audited, for the wholly owned ADSB subsidiary that was the general partner. *Id.* Like the prior version, the revised PPM provided no information concerning ADSB's financial condition. Although Rogers & Wells initially required that investor funds be held in escrow (Stip. ¶ 99), it authorized disbursement after receiving a letter dated July 8, 1985, from James Miller representing that ADSB had recorded gross profits of over $28 million on real estate transactions during the month of June, leaving it with a net worth of nearly $36 million. Stip. ¶ 103; E.R. 986-87. Miller based these figures on representations by Sahni, Day, Pope and ADSB's General Counsel, Gary Hinman, who each submitted a sworn declaration that the information was accurate and that he was unaware of any communication with regulators during the prior three months "questioning or expressing concern about the continuing viability of the Bank." E.R. 987, 991-94.

In fact, the representations from the ADSB officials upon which Rogers & Wells relied were false. In an audit completed in October 1986, Arthur Young found that, as of June 30, 1985, ADSB had a negative net worth of approximately $23 million. Stip. ¶ 203. Moreover, many of the June real estate transactions were sham sales that involved little or no down payment and were designed to provide a paper profit to offset ADSB's mounting losses. Stip. ¶¶ 74-75, 94-96. As a consequence, after the FHLBB appointed the FSLIC conservator, the FSLIC rescinded the Vineyard Way transaction. Stip. ¶¶ 207-08.

After closing the Vineyard Way transaction, ADSB issued a PPM for its Hickory Trace syndication. Like the Vineyard Way offering, the August 1 Hickory Trace PPM was prepared by Rogers & Wells; the PPM contained Arthur Young's March 31, 1985 audited financial statement for the ADSB subsidiary serving as general partner; and the PPM did not contain an audited statement for ADSB itself. Stip. ¶¶ 105, 106, 109.

In the weeks following issuance of the Hickory Trace PPM, Rogers & Wells attorneys who were working on a wide variety of different matters, including an audit inquiry, were apprised by ADSB officers and Arthur Young personnel of additional information concerning the bank's financial and regulatory problems. See E.R. 891-92, 910-28, 954-59. Following these disclosures, Rogers & Wells required ADSB to issue a revised, or "stickered," PPM for Hickory Trace, dated October 7, 1985, which provided that the transaction could not close unless an audited financial statement for ADSB was completed prior to the closing date. Stip. ¶¶ 115, 117. In December 1985, the Hickory Trace PPM was withdrawn and the investor funds returned. Stip. ¶ 118.

4. The Private Placement Memoranda Worked On By Petitioner

Shortly before Rogers & Wells required a "sticker" for the Hickory Trace PPM. ADSB decided to hire new counsel to handle two new syndications—Wells Park and Gateway Center. ADSB's General Counsel, Gary Hinman,

whom the FDIC later sued for concealing facts as part of an "unlawful conspiracy" to defraud investors in these two partnerships (E.R. 3060, 3073, 3075-76), explained that Rogers & Wells was too expensive. E.R. 3251. After interviewing a small number of firms, ADSB retained petitioner in mid-September for the limited purpose of assisting with the two new syndications. Petitioner was given a copy of the August 1 Hickory Trace PPM, which did not contain the "sticker," as a model for its work on the new syndications. Stip. ¶ 137.

It is undisputed that, prior to the federal take-over of ADSB, petitioner, unlike Rogers & Wells had no knowledge of ADSB's insolvency or valuation problems; the "stickered" Hickory Trace PPM; the May 3, 1985 letters that Touche Ross sent to state and federal regulators, Rogers & Wells and ADSB; or any of the correspondence and orders from state and federal regulators, all of which were unpublished (and, in the case of the FHLBB, confidental). E.R. 3316-17. Petitioner was insulated from such knowledge because no one at ADSB advised Rogers & Wells, Arthur Young, Touche Ross, or the FHLBB that ADSB had retained petitioner. Stip. ¶ 149. Indeed, ADSB retained a new accounting firm, Coopers & Lybrand, in late September 1985 to provide accounting services for the two transactions. Stip. ¶¶ 136, 147. This second change in auditors occured after James Miller advised Sahni, Day, and Pope, in early September, that the FHLBB had contacted Arthur Young to arrange a private meeting with the firm to discuss, among other things, a reappraisal of the Wells Park property. E.R. 1665.

ADSB issued the Wells Park PPM on October 17 and the Gateway Center PPM on November 25, 1985. Stip. ¶¶ 139, 150. Like the "unstickered" August 1 Hickory Trace PPM upon which they were based, the two PPMs petitioner helped prepare did not include an audited financial statement for ADSB. Instead, all three PPMs included copies of the March 31, 1985 statement audited by Arthur Young for the ADSB subsidiary that was the

general partner for both syndications. Stip. ¶¶ 143, 160. Arthur Young had never withdrawn its certification for this statement. Stip. ¶ 90. The Wells Park and Gateway Center PPMs also included financial and tax projections that Coopers & Lybrand prepared. Stip. ¶¶ 136, 147. These offerings were closed by ADSB on December 31, 1985, without participation by petitioner. E.R. 120, 124.

In preparing its tax opinion letters for these two PPMs, petitioner wrote to ADSB's director of syndications, Jeffrey Zoldos, setting forth the assumptions and representations from ADSB upon which petitioner had relied—including the representation that the PPM and its exhibits "are true and accurate in their entirety and [petitioner] may rely on them." E.R. 2516, 2524. Petitioner asked Zoldos if he was "aware of facts which could make any of the representations and assumptions . . . inaccurate." E.R. 2513, 2521. Although Zoldos was responsible for overseeing the legal and accounting work for the institution's syndications (E.R. 1399) and was knowledgeable about the Hickory Trace offering (Stip. ¶ 18), he made only minor corrections to the letters (*e.g.*, E.R. 2514, 2523), and did not reveal that the August 1 Hickory Trace PPM had been "stickered." In addition, ADSB made no change to representations concerning the value of the Wells Park property (see E.R. 2514), despite the fact that, eight days before petitioner wrote to Zoldos concerning the Wells Park PPM, FHLBB examiners had met with James Miller and Arthur Young personnel to advise them of valuation problems and other improprieties with respect to the Wells Park property and eight other ADSB investments. E.R. 1679A-1682.

5. Seizure Of ADSB And Initiation Of This Litigation

The meeting of FHLBB examiners with Miller and Arthur Young in early October followed shortly after a confidential September 18th letter to ADSB in which the FHLBB expressed serious concerns "regarding the condition and operations of [ADSB] and its service corpora-

tions." (E.R. 1705).[5] Thereafter, a succession of regulatory actions eventually led to the appointment of a conservator for the institution in February 1986. On November 22, 1985, state regulators advised ADSB that it was in violation of the 5% net worth requirement. Stip. ¶ 163. One week later, the FHLBB met with Sahni, Day, and ADSB's outside regulatory counsel[6] in an attempt to execute a new Supervisory Agreement. Stip. ¶¶ 163-64. ADSB refused to enter into any such agreement. Stip. ¶ 164. On December 13, state regulators issued a cease-and-desist order that restricted ADSB's investments in its subsidiaries and prohibited it from increasing its savings balance after January 1, 1986 unless it first submitted its overdue audited financial statement for 1985. Stip. ¶¶ 170-172. On December 17 and 19, the FHLBB directed ADSB to reduce its reported net worth by over $17 million. Stip. ¶¶ 173, 174.

Finally, on December 20, 1985, the FHLBB imposed severe operating restrictions on ADSB that were to remain in place until auditors confirmed that the bank had met its net worth requirements. Stip. ¶ 175. The very day the FHLBB imposed these restrictions, federal regulators learned of the two Wells Park and Gateway Center transactions, which were scheduled to close on December 31, 1985. Stip. ¶ 149. Although ADSB refused to provide additional information about these offerings, the regulators never contacted petitioner before the closing date. They also took no steps to prevent the scheduled closing, both of which took place on December 31. See

[5] By its letter of September 18th, which petitioner was never given, the FHLBB forwarded a report that showed that the thrift's net worth was unlikely to meet the 5% requirement established by state regulators; that the thrift's recognition of future losses would cause "a significant impairment of the institution's net worth"; and that the thrift's loans to syndications were "unsafe and unsound." E.R. 1709-28.

[6] Throughout the relevant period, the law firms of Leff & Mason and Fried, Frank, Harris, Shriver & Jacobson assisted ADSB in its dealings with state and federal regulators. Stip. ¶ 134. Petitioner performed no such services for the institution. E.R. 3255.

id. The closing of the Wells Park and Gateway Center transactions violated the December 20 FHLBB directive.[7]

On February 14, 1986, citing ADSB's insolvency, its dissipation of assets, and its " 'December 1985 Transactions,' many of which were in violation of supervisory directives" (E.R. 2640), the FHLBB appointed the FSLIC conservator of ADSB and dismissed the thrift's management, including Miller, Zoldos, Sahni, and Day. Stip. ¶¶ 200, 205. On February 19, 1986, the FSLIC brought suit against the latter two, seeking damages in excess of $60 million as a result of their breaches of fiduciary duty, fraud and, in the case of Sahni, RICO violations. Stip. ¶ 206; E.R. 3048.

In October 1986, the syndicated partnerships, now controlled by FSLIC as conservator for ADSB, rescinded the Vineyard Way, Wells Park and Gateway transactions and returned all sums invested, plus interest, to all unaffiliated investors. E.R. 2672-3003. In return, the partnerships received their full interest in the properties that were involved in the syndications. As a consequence, the investors were made whole, and ADSB, its subsidiaries, and the investors were placed in the same position vis-a-vis each other that they would have occupied had there been no closings. The sole exception was that ADSB and its subsidiaries had incurred out-of-pocket expenses—principally brokerage commissions and professional fees—as a consequence of the failed offerings. See *infra* p. 12 and note 10. On December 31, 1986, the FSLIC sued Hinman, seeking approximately $1.5 million in damages for his alleged negligence, fraud, and breach of fiduciary duties in connection with the Wells Park and Gateway Center syndications. See E.R. 3055-88. Nearly two and one-half years later, following its appointment as receiver for ADSB, the FSLIC initiated this action against petitioner.

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[7] Among other things, the FHLBB directive barred ADSB from engaging in any transaction with an affiliate. Stip. ¶ 175.

6. Proceedings Below

The FSLIC, as receiver of ADSB, sued petitioner in the United States District Court for the Central District of California for malpractice under California tort law seeking damages that ADSB suffered as a result of the two rescinded offerings on which petitioner worked. The FSLIC also sued on behalf of the Wells Park and Gateway Center investors.[8] The FDIC alleged that if petitioner had exercised the requisite care, it would have discovered the thrift's true financial condition.

After the FDIC was substituted for the FSLIC as a plaintiff, the district court granted petitioner summary judgment on all of the FDIC's claims. With respect to the investor-assigned claims, the court held that because all investors had been repaid in full, their interests were fully protected and the FDIC therefore had no claims to assert on their behalf. Pet. App. 18a-19a.[9] That ruling is not before this Court.[10]

With respect to the FDIC's claims on behalf of ADSB, petitioner argued that it owed no duty to its client to ferret out information that the client's owners and senior officers already knew and had failed to disclose to petitioner. Imputation of the knowledge of these persons to ADSB, petitioner argued, precluded any recovery by ADSB. Because the FDIC, as receiver, could assert no

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[8] In accepting the rescission offers, investors assigned to the FSLIC whatever rights, if any, they had against petitioner. Complaint ¶¶ 20, 31.

[9] This result reflects both the economic reality that no loss was suffered by any investor and the "one-satisfaction" rule. Under that rule, because the investors had received full compensation, they had no remaining claims to assert against (or assign to) anyone. *See Jaramillo* v. *California*, 81 Cal. App. 3d 968, 146 Cal. Rptr. 823 (1978).

[10] The Ninth Circuit left that ruling intact by limiting the FDIC's damages to the "out of pocket costs to the client [ADSB] properly attributable to the fraudulent transaction." Pet. App. at 15a. Indeed, on appeal, the FDIC did "not seek[] reimbursement for the rescission payments to the investors." *Id.*

greater rights than ADSB, its claims failed. The district court agreed, and granted summary judgment as to these claims as well. Pet. App. 19a.

The Ninth Circuit reversed. Purporting to look to California law as the source of petitioner's duty to its client (Pet. App. 6a-8a), the court of appeals relied on principles derived from federal securities law in determining that this duty included an obligation to investigate representations made by a client's senior officers and owners. *Id.* at 8a-9a. Whether or not petitioner had discharged this duty, the court held, was a question of fact that could not be resolved on summary judgment. *Id.* at 9a.

The Ninth Circuit acknowledged, however, that the existence of an issue as to petitioner's compliance with this duty was not dispositive of whether a viable claim existed. The court accepted the "unexceptionable general principle that the perpetrator of a fraud cannot be a victim of that fraud." *Id.* at 10a. The court further accepted that ADSB's owners and senior officers, Sahni and Day, could not have pursued any claim against petitioner. *Id.* The issues before the court of appeals were whether the wrongdoing of Sahni and Day, and their knowledge of that wrongdoing, were to be imputed to ADSB, their wholly owned corporation, and whether this defense applied to the FDIC as receiver.

The Ninth Circuit decided both issues by creating federal rules of decision that are contrary to California law. See *id.* at 13a (holding that federal law governs "the application of defenses against FDIC"). First, relying solely on federal court decisions, the court reasoned that the knowledge of miscreant owners and officers could not be imputed to ADSB because those insiders had benefited and ADSB's insolvency had been "aggravat[ed]." *Id.* at 12a. Second, the court concluded that, even if imputation to ADSB were proper, federal law precluded defenses against the FDIC based on "the bank's inequitable conduct" because this would "diminish[] the value of the asset pool held by the receiver." *Id.* at 15a.

SUMMARY OF ARGUMENT

I. Where Congress addresses a subject, separation of powers principles require that federal courts not exercise their limited and extraordinary power to create federal common law in order to alter the remedies Congress has adopted. See, *e.g., Northwest Airlines, Inc.* v. *Transport Workers Union*, 451 U.S. 77, 95-97 (1981). Here, Congress has addressed the FDIC's rights as receiver. See 12 U.S.C. § 1821(d)(2)(A). The express language of that statutory provision makes clear that in this case the FDIC as receiver is asserting the rights of the savings and loan. As a receiver, the FDIC asserts ADSB's tort claims subject to preexisting defenses, including petitioner's imputation defense. See, *e.g., Rankin* v. *City Nat'l Bank*, 208 U.S. 541, 546 (1908); *cf. Coit Independence Joint Venture* v. *FSLIC*, 489 U.S. 561, 571, 585 (1989).

Congress understood, as has this Court, that state law governs a federally insured financial institution's tort claims and the defenses thereto. See *Bank of America Nat'l Trust & Sav. Ass'n* v. *Parnell*, 352 U.S. 29, 33-34 (1956). Congress provided the FDIC no special immunity from the state law imputation defense asserted by petitioner. This is important because when Congress believed state law was inadequate, Congress *expressly* created either a federal cause of action or an exception to specific state law defenses. In this instance, Congress did neither.

Finally, Congress expressly adopted the remedies it believed appropriate to regulate the conduct of attorneys who represent savings and loans; it included no federal cause of action for the alleged negligence at issue in this case, however, and instead provided administrative remedies that reach only knowing or reckless misconduct. Any cause of action for, and defenses to, alleged attorney negligence were left to state law. The court below improperly upset the careful balance Congress set forth in the statute by using federal common law to abrogate state-law defenses that Congress left undisturbed.

II. Even if Congress had not specifically addressed the rights the FDIC possesses as receiver of a failed savings institution, the Ninth Circuit still erred in creating a uniform federal rule of decision in this case. The FDIC has not made, and cannot make, the showing necessary to overcome this Court's presumption that state law provides the proper rule of decision. *E.g., United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715, 728-42 (1979).

First, the FDIC does not in fact seek a nationally uniform body of law. Instead, the FDIC routinely bases its claims against attorneys and other professionals on duties created by differing state laws, and seeks only to abrogate those aspects of state law, such as defenses based on imputation, that stand as obstacles to its success. The FDIC's desire for uniform *outcomes* provides no justification for displacing state law. See, *e.g., Kimbell Foods,* 440 U.S. at 729-32; *United States* v. *Yazell,* 382 U.S. 341, 346, 357 (1966). Moreover, here California law applies well-established principles of imputation that are followed throughout the country.

Second, application of state law does not frustrate specific federal objectives. The government's desire to recover more money in civil litigation provides an insufficient basis for judicial creation of a uniform federal rule of decision, particularly because federal financial institution legislation pursues a number of competing social and economic goals. See, *e.g., Kimbell Foods,* 440 U.S. at 735-37, 739 & n.43; *Yazell,* 382 U.S. at 348-49. Indeed, the rule sought by the FDIC impedes important statutory objectives, such as ensuring affordable lending and the availability of professional services at reasonable cost. Congress, not the federal judiciary, is best able to balance the competing policy goals, and, in striking that balance here, Congress provided other mechanisms for protecting the federal fisc.

Finally, the creation of a uniform federal rule of decision here would severely and improperly disrupt commercial relationships that are predicated on state law. See *Kamen* v. *Kemper Fin. Servs.,* 111 S. Ct. 1711, 1717

(1991). Under our system of federalism, tort liability and attorney-client relationships are areas traditionally governed by state law. Lawyers perform services, charge fees, and obtain malpractice insurance on an understanding of their duties and possible liability under well-established state rules. The Ninth Circuit's decision to change those rules years after the services at issue were provided highlights the fundamental unfairness of allowing courts to create uniform federal rules of decision in this area.

ARGUMENT

I. THE FEDERAL COURTS MAY NOT CREATE FEDERAL COMMON LAW TO ALTER THE REMEDIES PROVIDED BY CONGRESS.

A. When Congress Addresses A Subject, There Is No Further Role For Federal Common Law.

This Court has repeatedly held that "once Congress addresses a subject, even a subject previously governed by federal common law, the justification for lawmaking by the federal courts is greatly diminished. Thereafter, the task of the federal courts is to interpret and apply statutory law, *not to create common law.*" *Northwest Airlines, Inc.* v. *Transport Workers Union,* 451 U.S. 77, 95 n.34 (1981) (emphasis added); accord *City of Milwaukee* v. *Illinois,* 451 U.S. 304, 314 (1981). As the Court has explained, "[o]ur 'commitment to the separation of powers is to fundamental' to continue to rely on federal common law 'by judicially decreeing what accords with "common sense and the public weal"' when Congress has addressed the problem." *Id.* at 315 (quoting *TVA* v. *Hill,* 437 U.S. 153, 195 (1978)).[11]

When the Court finds that a statute addresses a subject, the statute then is "the exclusive source of *federal* law"

[11] Indeed, even when there is preexisting federal common law on an issue, which is not the case here, this Court has expressed its "willingness to find congressional displacement of *federal* common law" by a subsequent statute. *City of Milwaukee,* 451 U.S. at 317 & n.9 (emphasis in original).

on the subject. *Id.* at 319 n.14 (emphasis in original). This does *not* mean, however, that state law is preempted. *Id.* To the contrary, the Court has made plain that in situations where federal common law may not be used to supplement federal statutory remedies, state law retains its normal ability to provide such supplementary remedies. See *id.* at 319 n.14, 323-24, 328. In such circumstances, "[a]lthough a federal court may disagree with the . . . approach taken" under state law toward additional remedies, "such disagreement alone is no basis for the creation of federal common law." *Id.* at 323. In this way the Court both respects Congress' preeminent role in promulgating rules of law and the plain dictates of federalism and the Rules of Decision Act, 28 U.S.C. § 1652, which require state law to be followed unless there is a clear federal basis for employing a contrary federal rule.

The Court's decision in *Langley* v. *FDIC*, 484 U.S. 86 (1987), exemplifies the carefully restricted role of federal common law once a federal statute addresses a subject. In *Langley*, borrowers sought to raise a defense to liability on a note based on an unwritten side arrangement. *Id.* at 88-89. Had federal common law applied, the opinion of the Court would have been extremely short because such a secret arrangement fell squarely within the federal common law prohibition of *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447, 460 (1942), which the FDIC had urged as an alternative ground for affirmance. See *Langley*, 484 U.S. at 92. Instead, the Court stated that the issue was whether the borrowers' secret arrangement constituted an "agreement" under 12 U.S.C. § 1823(e), which had been enacted after *D'Oench*. See *id.* at 90-96. The Court focused exclusively on the statutory provision, refering to *D'Oench* only as an aid in interpreting the statute. See *id.* at 92-93.

In particular, the Court in *Langley* made plain that it would not protect asserted federal interests that were not protected by the language of the statute. First, the Court indicated that if there were fraud in the factum

against the borrower, the FDIC could not acquire "right, title, or interest" under 12 U.S.C. § 1823(e) and thus could not rely on any federal exemption from that defense. *Id.* at 93-94. Second, the Court explained that the FDIC could not avoid an agreement that satisfied the recordkeeping requirements of § 1823(e), "even if the FDIC did not know of" the agreement, regardless of the policy arguments advanced by the FDIC. *Id.* at 95. The Court emphasized: "It would be rewriting the statute to hold otherwise." *Id.*

This Court should begin where *Northwest Airlines*, *City of Milwaukee*, and *Langley* begin, and with what the Ninth Circuit ignored: the statute. Because the statute addresses the subject at issue, the Court's analysis should also end there.

B. Under 12 U.S.C. § 1821(d)(2)(A), The FDIC Succeeds To The Claims Of The Failed Institution.

Congress has enacted an extensive series of statutory provisions applicable to savings and loans and to the FDIC as receiver of savings and loans. See, *e.g.*, 12 U.S.C. §§ 1421-1470, 1811-1834b. This "comprehensive program" of statutory provisions by itself "strongly suggests that there is no room for courts to attempt to improve on that program with federal common law." *City of Milwaukee*, 451 U.S. at 319.

Most specifically, Congress has expressly addressed the nature of the rights possessed by the FDIC as receiver of a savings and loan, and thus the claims the FDIC can assert. Under 12 U.S.C. § 1821(d)(2)(A), which is titled "Successor to institution," the FDIC "as conservator or receiver, and by operation of law, succeed[s] to— (i) all rights, titles, powers, and privileges of the insured depository institution." [12] This provision applies here to

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[12] Under 12 U.S.C. § 1821(d)(2)(A)(i), the FDIC also succeeds to "all rights, titles, powers, and privileges . . . of any stockholder, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution." This portion of the statutory provision is not at issue in

the FDIC as successor receiver to the FSLIC.[13]

It is evident from the plain language of § 1821(d)(2)(A) that the FDIC as receiver has succeeded to and thus asserts as its claims the "rights . . . of the insured institution." Indeed, treating the FDIC as a successor also accords with both the natural meaning of "receiver" and prior judicial construction of the rights possessed by a "receiver." It is a well-settled rule of statutory interpretation that "[w]hen Congress codifies a judicially defined concept, it is presumed, absent an express statement to the contrary, that Congress intended to adopt the interpretation placed on that concept by the courts." *Davis* v. *Michigan Dep't of Treasury,* 489 U.S. 803, 813 (1989). When Congress enacted FIRREA, it was established that a federal receiver, including a receiver of a failed savings and loan, "steps into the shoes of the association and takes control of *its* assets." *Coit Independence Joint Venture* v. *FSLIC*, 489 U.S. 561, 571 (1989) (emphasis added); see also *id.* at 585. This Court's decisions have emphasized that, in acting as a successor to a failed institution, a federal receiver is subject to defenses available against that institution. Thus, in *Scott* v. *Armstrong,* 146 U.S. 499, 507 (1892), the Court held:

> The receiver took the assets of the [national bank] . . . , in the absence of statute to the contrary, subject to all claims and defences that might have been interposed as against the insolvent corporation . . . .

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this case as the FDIC does not assert a claim as successor to any of the listed persons. Moreover, pursuant to the phrase "with respect to the institution and the assets of the institution," the FDIC succeeds only to the rights of the listed persons to bring derivative suits to enforce claims of the institution, not to direct claims of the listed persons. *See, e.g., In re Atl. Fin. Fed. Secs. Litig.*, 1991 Fed. Sec. L. Rep. (CCH) ¶ 96,038 (E.D. Pa. 1991).

[13] *See* 12 U.S.C. § 1821a(a)(5)(B). In any event, the statutory provisions applicable in June 1988 stated that the FSLIC as receiver succeeded to the "assets of . . . such association" and the "claims in favor of . . . the insured institution[]." 12 U.S.C. § 1729(b)(1)(A)(i), (d) (1982 & Supp. V).

Accord *Rankin* v. *City Nat'l Bank,* 208 U.S. 541, 546 (1908) (same); *Fourth Street Nat'l Bank* v. *Yardley,* 165 U.S. 634, 653 (1897) (same).[14] In particular, *Armstrong* v. *Ashley,* 204 U.S. 272, 283 (1907), holds that a federally appointed receiver is subject to an imputation defense.

Ignoring this Court's prior rulings on the rights of a receiver, the Ninth Circuit reasoned that the FDIC as a receiver should not be subject to defenses available against the thrift because a receiver, like a bankruptcy trustee, is an involuntary transferee. See Pet. App. 14a. The analogy to a bankruptcy trustee, however, in fact undermines the decision below. This Court has expressly held that when a bankruptcy trustee pursues claims as successor to an insolvent debtor, "[t]he trustee succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition." *Bank of Marin* v. *England,* 385 U.S. 99, 101 (1966); *cf. Butner* v. *United States,* 440 U.S. 48, 54-56 (1979) (unless there is an express statutory cause of action, bankruptcy trustee's rights are "defined by state law"; "undefined considerations of equity provide no basis for adoption of uniform federal rule").

That Congress adopted the traditional understanding of the word "receiver" is confirmed by the fact that Congress created a number of *express* statutory exceptions to the rule that the receiver is subject to defenses against

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[14] *See also* 2 R. Clark, *A Treatise on the Law and Practice of Receivers* § 362, at 619-20 (3d ed. 1959) (footnote omitted) ("The Supreme Court of the United States and federal authorities hold that the receiver of a bank stands in no better position than the bank stood as a going concern and when the bank was a party to an illegality, the court will leave the parties where it finds them by refusing relief to the receiver of such a bank."), and cases cited therein; 16 W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 7847, at 542 (perm. ed. 1989) (footnote omitted) (same), and cases cited therein. Similar principles apply when the United States asserts a claim as assignee. *See Guaranty Trust Co.* v. *United States,* 304 U.S. 126, 141-42 (1938).

the institution. Thus, 12 U.S.C. §§ 1821(d)(9) and 1823(e) bar defenses against the receiver based on an agreement of the institution that was either not written or not properly approved and recorded. Section 1821 (d)(14) extends the statute of limitations beyond that period which otherwise still exists under state law. Section 1821(e) allows the receiver to repudiate prospectively certain contracts and precludes claims for specific performance as well as certain damages. And section 1821(k) creates a cause of action against directors and officers for gross negligence, even if the applicable state's law would itself require greater culpability.

In stark contrast to these provisions, Congress did not enact *any* statutory exception to the general rule that the receiver is subject to defenses available against the institution that is applicable to the imputation issue in this case. This omission is particularly important because Congress understood that Section 1821 of Title 12 serves as a "common code" for the rights of the FDIC as receiver. S. Rep. No. 19, 101st Cong., 1st Sess. 313 (1989); see also H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 415 (1989) (1989 amendments to § 1821 are "comprehensive"). It is inappropriate for the federal courts to use federal common law to create a rule of law that Congress has not seen fit to adopt. See *Wallis* v. *Pan American Petroleum Corp.*, 384 U.S. 63, 70 (1966) (congressional enactment of some "statutory defenses" provides "no reason for creating at large a federal common law"); *UAW* v. *Hoosier Cardinal Corp.*, 383 U.S. 696, 703-04 (1966) (where Congress legislates some specific exceptions to state law, Court should not "invent" others); *Walsh v. Ford Motor Co.*, 807 F.2d 1000, 1016 (D.C. Cir. 1986) ("Particularly in an area traditionally in the state's domain, . . . the likelihood is that the national legislature, when it intervenes, and does not say otherwise, opts for the little rather than the much."), *cert. denied*, 482 U.S. 915 (1987).[15]

[15] *Cf. Coit Independence Joint Venture* v. *FSLIC*, 489 U.S. 561, 574 (1989) (because Congress had explicitly given FSLIC adjudicatory authority in its supervisory capacity, it was not "reasonable to infer that . . . Congress intended to confer adjudicatory authority upon FSLIC in its receivership capacity . . ."). Of course, if Congress did pass legislation creating millions of dollars of liability to the government that did not previously exist, serious constitutional questions would be raised if that legislation were to be applied retroactively. *See Perry* v. *United States*, 294 U.S. 330, 350-51 (1935); *Lynch* v. *United States*, 292 U.S. 571, 579-80 (1934).

C. Congress Understood That State Law Governs The Tort Claims Of The Institution.

As shown above, under 12 U.S.C. § 1821(d)(2)(A)(i) the FDIC succeeds to and asserts the claims of the institution. Accordingly, for the FDIC to prevail in its efforts to avoid applicable defenses under California law, the FDIC must convince this Court that federal law governs *the tort claims of the savings and loan itself*. There is no support for this extraordinary expansion of federal law and, indeed, federal court jurisdiction.[16]

To the contrary, Congress understood that state law had traditionally controlled and would continue to govern

[16] Congress has provided for federal court jurisdiction on the basis that the FDIC is a plaintiff. *See* 12 U.S.C. § 1819(b). Of course, "[t]he vesting of jurisdiction in the federal courts does not in and of itself give rise to authority to formulate federal common law." *Texas Indus., Inc.* v. *Radcliff Materials, Inc.*, 451 U.S. 630, 640-41 (1981); *see also Campbell* v. *Haverhill*, 155 U.S. 610, 616 (1895) (Rules of Decision Act, 28 U.S.C. § 1652, applies in federal-question cases). Congress has *not* enacted a provision providing federal court jurisdiction on the basis that a savings and loan is a plaintiff. To the contrary, the removal provision enacted for suits when the FDIC is substituted as a party reflects the understanding of Congress that ordinarily savings and loans will sue in state court. *See* 12 U.S.C. § 1819(b)(2)(B). The application of federal law to ADSB's claims would thus create a whole new class of federal court jurisdiction.

Moreover, three of the plaintiffs here are ADC Financial Corporation (ADCFC), a California corporation, and two partnerships in which ADCFC is the general partner. These three entities were not federally insured and have never been in FDIC conservatorship or receivership. No one has ever contended that federal law applies to their claims and the defenses thereto.

the tort claims of savings and loans. As this Court has recognized, "[e]ven where there is related federal legislation in an area, as is true in this instance, it must be remembered that 'Congress acts . . . against the background of the total *corpus juris* of the states . . . .'" *Pan American Petroleum Corp.*, 384 U.S. at 68 (quoting Hart & Wechsler, *The Federal Courts and the Federal System* 435 (1953)). Tort law is, of course, one of the most traditional areas of state law preeminence. See *Erie R.R.* v. *Tompkins*, 304 U.S. 64, 78 (1938).

In this case, the statutory provisions enacted by Congress reflect Congress' understanding that state law governs the tort claims of savings and loans and their receivers, except when an express federal statutory provision specifies to the contrary. Thus, when Congress enacted a statute of limitations provision, the provision expressly supplemented the limitations period "applicable under State law." 12 U.S.C. §1821(d)(14)(A). Similarly, when Congress provided that the FDIC could bring a federal "gross negligence" claim against directors and officers, Congress both understood that this statutory provision would preempt certain otherwise applicable state laws, see H.R. Conf. Rep. No. 222, 101st Cong., 1st Sess. 398 (1989),[17] and instructed courts to adopt "applicable State law" to define and determine what constituted gross negligence, 12 U.S.C. § 1821(k). The legislative history emphasizes that Congress understood that the preemptive

[17] Numerous other provisions of FIRREA also expressly preempt state law. *See, e.g.*, 12 U.S.C. §§ 1441a(g); 1441b(f)(7); 1463(g)(1); 1467(i)(3); 1787(c)(8)(A) and (E), (e)(1), (f)(1); 1825(a); 1831e(a), (e)(1). None of the statutory provisions preempting state law applies to the issue in this case.

Congress also considered, and the Senate passed, a provision that would have deviated from state law by giving a priority to FDIC claims against "an insured financial institution's director, officer, employee, agent, *attorney*, accountant, appraiser" or other service provider over claims of creditors, depositors, or shareholders. S.774, 101st Cong., 1st Sess., § 214(o) (1989) (emphasis added). The provision was deleted in conference and has never been enacted by Congress.

effect of section 1821(k) "is very limited in scope . . . . [N]or does it represent a major step in the direction of establishing Federal tort standards." 135 Cong. Rec. S4277 (daily ed. April 19, 1989) (Sen. Sanford). And, as previously noted, Congress envisioned that savings and loans would bring tort claims in state courts, not federal courts. See *supra* p. 23 and note 16.

Moreover, when FIRREA was enacted in 1989, it was undisputed that the tort claims by and against savings and loans were governed by state law.[18] Indeed, the great weight of authority held that state law also supplied the rule of decision applicable to the tort claims asserted by federal receivers for failed banks or savings and loans.[19]

Notably, this Court had held that state law, not federal common law, applied to a tort suit by a federally insured

[18] *See, e.g., Astrup* v. *Midwest Fed. Sav. Bank*, 886 F.2d 1057, 1059 (8th Cir. 1989); *FDIC* v. *Braemoor Assocs.*, 686 F.2d 550, 554 (7th Cir. 1982), *cert. denied*, 461 U.S. 927 (1983); *FDIC* v. *Clark*, 1989 U.S. Dist. LEXIS 17556, at *22-*23 (D. Colo. 1989), *aff'd*, 978 F.2d 1541 (10th Cir. 1992); *FSLIC* v. *Frumenti Dev. Corp.*, 676 F. Supp. 957, 962 (N.D. Cal. 1988), *app. dismissed*, 857 F.2d 665 (9th Cir. 1988); *FDIC* v. *Blackburn*, 109 F.R.D. 66, 71 (E.D. Tenn. 1985); *FDIC* v. *Abraham*, 501 F. Supp. 221, 223-24 (E.D. La. 1980).

[19] *See, e.g., FSLIC* v. *Quality Inns, Inc.*, 876 F.2d 353, 359 (4th Cir. 1989) (breach of fiduciary duty); *FSLIC* v. *Capozzi*, 855 F.2d 1319, 1324-25 (8th Cir. 1988) (breach of fiduciary duty), *vacated on other grounds*, 490 U.S. 1062 (1989); *Trigo* v. *FDIC*, 847 F.2d 1499, 1502-03 n.4 (11th Cir. 1988) ("when acting as receiver, the FDIC is governed by state law"); *FSLIC* v. *Ticktin*, 832 F.2d 1438, 1445-46 (7th Cir. 1987), *rev'd on other grounds*, 490 U.S. 82 (1989); *Warner* v. *Central Trust Co.*, 798 F.2d 167, 172 (6th Cir. 1986); *American Nat'l Bank* v. *FDIC*, 710 F.2d 1528, 1540-41 (11th Cir. 1983) (constructive trust); *FDIC* v. *Braemoor Assocs.*, 686 F.2d at 554 (breach of fiduciary duty); *Atkinson* v. *FDIC*, 635 F.2d 508, 511 (5th Cir. 1981) (set-off); *FDIC* v. *Clark*, 1989 U.S. Dist. LEXIS 17556, at *15-*24 (proportionate fault); *FSLIC* v. *Frumenti Dev. Corp.*, 676 F. Supp. at 961-64 (fraud, negligent misrepresentation); *FSLIC* v. *Huff*, 631 F. Supp. 1350, 1354 (D. Kan. 1986) (fraud); *FDIC* v. *Abraham*, 501 F. Supp. at 223-24 (breach of fiduciary duty, laches, contribution); *Jacobson* v. *FDIC*, 407 F. Supp. 821, 827 (S.D. Iowa 1976) (discharge).

savings association for conversion of bonds issued by the Home Owners Loan Corporation and guaranteed by the United States. See *Bank of America Nat'l Trust & Sav. Ass'n* v. *Parnell*, 352 U.S. 29, 33 (1956). The Court did so even though the issues raised by the suit might ultimately affect the federal treasury. *Id.* at 33-34; see also *Coit Independence Joint Venture* v. *FSLIC*, 489 U.S. at 585 (borrower's multi-million dollar claims for savings and loan's alleged torts were "state law claims"); *cf. Miree* v. *DeKalb County*, 433 U.S. 25, 31-32 (1977) (state law applies to entities subject to substantial federal regulation even though a federal common law rule would "advance federal . . . policy by inducing compliance with [regulatory] provisions").

The Court should find that when Congress enacted FIRREA it intended to leave intact the established case law under which tort claims of savings and loans are governed by state law. See, *e.g.*, *Cottage Sav. Ass'n* v. *Commissioner*, 111 S. Ct. 1503, 1508-09 (1991). In its periodic revisions of federal financial institution legislation, Congress has not been reticent expressly to overrule existing judicial doctrines and decisions, including those from lower courts. See, *e.g.*, H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 418-19, 468 (1989); S. Rep. No. 19, 101st Cong., 1st Sess. 384, 386 (1989). Here, no statutory provision overrules the cases holding that the tort claims of savings and loans are governed by state law.

D. Congress Created The Remedies It Deemed Appropriate To Regulate Attorney Representation Of Savings And Loans.

There can be no doubt that Congress knew how to create an express statutory federal cause of action for damages in favor of federal receivers. Indeed, it twice did so for the FDIC for fraudulent conveyances and for gross negligence by directors and officers. See 12 U.S.C. §§ 1821(d)(17), 1821(k). The absence of such a statutory cause of action against attorneys weighs heavily against creating a federal common law remedy that Congress did not enact. See *RFC* v. *Beaver County*, 328 U.S. 204, 209 (1946).

Instead of creating a federal cause of action against attorneys, Congress granted the thrift regulatory agency, the Office of Thrift Supervision (OTS), additional administrative enforcement powers against attorneys. Specifically, Congress provided that if an attorney "knowingly or recklessly participates" in a "violation of any law or regulation," a "breach of fiduciary duty," or an "unsafe or unsound practice," that causes a significant loss to a savings and loan, the attorney becomes an "institution-affiliated party." 12 U.S.C. § 1813(u). Status as an "institution-affiliated party" subjects the attorney to certain administrative remedies, including orders issued by OTS (1) to cease and desist certain actions, (2) removing the attorney from serving as counsel to the savings and loan, or (3) prohibiting the attorney from ever participating in the conduct of the affairs of any federally insured depository institution. *Id.* § 1818(b), (e); see also *id.* § 1813(q)(4). As part of a cease-and-desist order, OTS may require an attorney who engages in reckless or knowing misconduct to "make restitution or provide reimbursement, indemnification, or guarantee against loss" if the attorney was "unjustly enriched" or had a "reckless disregard for the law or any applicable regulations or prior [agency] order." *Id.* § 1818(b)(6)(A).

The administrative remedies adopted by Congress are deliberately narrow in scope. Indeed, in a number of respects the administrative remedies are *narrower* than those available under California law or the common law of other States. Most importantly, before being subject to any administrative action, the attorney must be found to have acted "recklessly," not merely negligently as under California law.[20] And an even more culpable

[20] **The legislative history explains that Congress "does not intend to subject attorneys to agency enforcement actions for those good faith activities falling within the traditional attorney-client relationship. Specifically, providing advice in good faith to a client financial institution, by itself, should not lead to an enforcement**

mental state is required for the limited forms of monetary relief available under 12 U.S.C. § 1818(b)(6). Finally, the doctrine of vicarious liability does not apply to the law firm that employs the wrongdoing attorney.[21]

It would upset the carefully balanced scheme enacted by Congress if the federal courts, under the guise of federal common law, were to fashion a remedy for conduct that is actionable under neither the administrative provisions of federal statutory law nor the standards of California common law. Congress plainly expected that any supplement to the administrative remedies available against attorneys would come from state law. See H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 467 (1989) (administrative enforcement provisions "in no way affect the ability of the AICPA, State Bar agencies or other State licensing agencies to take disciplinary action or of plaintiffs to bring malpractice cases"). This Court has repeatedly held that it will not use federal common law to supplement the remedies chosen by Congress. See *Halcyon Lines* v. *Haenn Ship Ceiling & Refitting Corp.*, 342 U.S. 282, 285-87 (1952) ("because Congress while acting in the field has stopped short of approving the rule . . . here urged, we think it would be inappropriate for us to do so"); accord *Northwest Airlines*, 451 U.S. at

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action." H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 467 (1989); *see also id.* at 392 ("[t]his section limits the exposure of independent contractors").

[21] The report of the House Banking Committee states:

> Concern was also expressed that a banking agency could obtain enforcement orders against a . . . partnership, such as a large . . . law firm . . . . Accordingly, the Committee expects the banking agencies to limit enforcement actions in the usual case to individuals who have participated in the wrongful action, to prevent unintended consequences or economic harm to innocent third parties.
>
> However, the Committee strongly believes that the agencies should have the power to proceed against such entities if most or many of the managing partners or senior officers of the entity have participated in some way in the egregious misconduct.

H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 466-67 (1989).

97-98; *Texas Indus.*, 451 U.S. at 644-45; *City of Milwaukee*, 451 U.S. at 320, 328; *Mobil Oil Corp.* v. *Higginbotham*, 436 U.S. 618, 623-25 (1978). But that is precisely what the FDIC has asked the federal courts to do.

E. Congress Has Balanced The Competing Policies And Did Not Leave The Issues In This Case For Federal Common Law To Resolve.

Congress' decision to leave redress of alleged attorney negligence to state law reflects a number of policy considerations important to Congress. In particular, a number of policy considerations support Congress' decision not to preempt imputation defenses recognized under state law. These considerations include: (1) Principles of federalism counsel respect for state law, particularly in such traditional state-law areas as tort law and the professional responsibilities of lawyers. (2) Principles of fairness and proximate causation counsel that it is reasonable to differentiate between an attorney who fails to discover what the owners and officers of his or her client are hiding and an attorney either who acts with knowledge or whose client's owners and officers are ignorant of the true facts. See *infra* pp. 38-39. (3) There also are a host of adverse consequences that could result from an expansion of professional liability. It will encourage some attorneys to withdraw from representing saving and loans, and others to raise their fees to otherwise unnecessary levels to compensate for the increased risks. It could also cause insurers to refuse to cover an attorney who represents a savings and loan. Those attorneys who remain in the field might well be less careful and scupulous than those who leave. Alternatively, the remaining attorneys might be so worried about their own liability that they would create unnecessary impediments even to sound transactions—thus exacerbating the current credit crunch. *Cf. Pinter* v. *Dahl*, 486 U.S. 622, 654 n.29 (1988) (expanding liability of professionals "risks over-deterring activities related to lawful" trans-

actions). It cannot be disputed that in FIRREA and related legislation, Congress considered to be important a number of these kinds of policy considerations. See *supra* pp. 24-25, 27-28 and notes 20-21; *cf.* 12 U.S.C. § 1821(d)(2)(E) (in realizing "upon the assets of the institution," receiver should have "due regard to the conditions of credit in the locality"); H.R. Rep. No. 54(I), *supra,* at 436, ("The inability to obtain credit at reasonable rates is a major factor in the decline of many communities in our nation."); S. Rep. No. 1482, 89th Cong., 2d Sess. 7 (1966) ("The committee did not wish to take any action which would do violence to the balance between State and Federal functions and responsibilities which underlies the dual banking system and the dual savings and loan system.").

The FDIC's competing policy arguments in favor of supplanting state law should be addressed to Congress, not the courts.[22] It is axiomatic that when, as here, Congress has balanced the competing policies in an area, the federal courts cannot use federal common law to reset that balance. See, *e.g., Northwest Airlines,* 451 U.S. at 98 ("a favorable reaction to the equitable considerations [advanced by a claimant] is not a sufficient reason for enlarging on the remedial provisions contained in these carefully considered statutes"); *Mobil Oil,* 436 U.S. at 623 ("[W]e need not pause to evaluate the opposing policy arguments. Congress has struck the balance for us."); *id.* at 624 ("a desire for uniformity cannot override the statute"). This principle is fundamental to the allocation of powers in our constitutional system. Here, Congress made the policy choice not to craft federal standards of attorney liability for alleged negligence. Instead, 12 U.S.C. § 1821(d), which contains no exception for claims against or defenses of attorneys, requires the

[22] *See, e.g., Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 214 n.33 (1976) (expanding the "hazards" of providing professional services involves "serious policy questions" best addressed by Congress).

application of state law to this case and the reversal of the Ninth Circuit's decision. See *supra* pp. 19-26.

* * *

In sum, Congress has left no room for judicial creation of a federal rule of decision to govern the tort claims of the FDIC as the receiver of a failed thrift. Congress dealt comprehensively with the entire question of failed thrifts and carefully chose to place the FDIC in the traditional and well-understood role of a receiver. Not only is Congress presumed to know the rights and limitations of a receiver recognized under preexisting law, but Congress also repeatedly manifested its actual knowledge as to how state law cabins the extent of a receiver's claims. When Congress found the federal interest to be inadequately protected by state law, Congress dealt directly and specifically with the problem in the statute itself. Congress has acted on the subject at issue in this case, and thus, federal courts may not create new federal common law rules that supplant the rights and remedies—both state and federal—embodied in the statute.

II. UNDER *KIMBELL FOODS,* STATE LAW SUPPLIES THE RULE OF DECISION.

When this Court addresses whether to create a federal rule of decision, a "presumption" exists that state law supplies the applicable rule of decision. *Kamen* v. *Kemper Fin. Servs.,* 111 S. Ct. 1711, 1717 (1991). This presumption rests on the fundamental premise that principles of separation of powers and federalism require that judicial creation of a uniform federal rule of decision be exceedingly rare:

> Federal courts, unlike state courts, are not general common-law courts and do not possess a general power to develop and apply their own rules of decision . . . . The enactment of a federal rule in an area of national concern, and the decision whether to displace state law in doing so, is generally made not by the federal judiciary, purposefully insulated from democratic pressures, but by the people through their elected representatives in Congress.

City of Milwaukee v. *Illinois,* 451 U.S. 304, 312-13 (1981); see also *Wheeldin* v. *Wheeler,* 373 U.S. 647, 651 (1963) (use of federal common law to create a uniform federal rule of decision is limited to "few and restricted" instances).

The Court's reluctance to create a uniform federal rule of decision is properly greatest when, as here, there are substantial policy arguments opposed to the proposed uniform rule. As Justice Harlan wrote for the Court in *United States* v. *Brosnan,* 363 U.S. 237, 251-52 (1960), in assessing whether the pecuniary interests of the United States justified creating a federal rule of decision:

> It must be recognized that the factors supporting a federal rule of uniformity in this field, and those militating against the dislocation of long-standing state procedures, are full of competing considerations. They involve many imponderables which this Court is ill-equipped to assess, on which Congress has not yet spoken, and which we think are best left to that body to deal with in light of their full illumination. A wise solution of such a far-reaching problem cannot be achieved within the confines of a lawsuit. Until Congress otherwise determines, we think that state law is effective . . . .

Similarly, in *United States* v. *Kimbell Foods, Inc.,* 440 U.S. 715 (1979), this Court also declined to resolve conflicting policy arguments, including the government's desire to recover more money, by creating a uniform federal rule of decision. The Court explained:

> Because the ultimate consequences of altering settled commercial practices are so difficult to foresee, we hesitate to create new uncertainties in the absence of careful legislative deliberation . . . . Thus, the prudent course is to adopt the ready made body of state law as the federal rule of decision until Congress strikes a different accommodation.

Id. at 739-40.[23] Accordingly, any analysis of whether to create a uniform federal rule of decision must reflect the Court's respect for both Congress and the States as the principal sources of substantive law, as well as the Court's prudent assessment of the limited capacity of federal courts to make complex policy—indeed, essentially legislative—decisions.

Kimbell Foods sets forth three basic factors to assist the Court in deciding whether the presumption in favor of state law has been overcome. The Court considers: (1) whether the vindication of federal interests requires a "nationally uniform body of law"; (2) "whether application of state law would frustrate specific objectives of the federal programs"; and (3) "the extent to which application of a federal rule would disrupt commercial relationships predicated on state law." 440 U.S. at 728-29. These standards are framed to minimize significantly the likelihood that the courts will create federal rules of decision. The uniform body of law must be a necessity; the interference must be with discrete and identifiable federal interests; and, even still, state law ought to be employed when the effect of a federal rule would be to frustrate commercial expectations. As applied to this case, all three of these factors conclusively favor state law.

A. There Is No Need For The Federal Courts To Create A "Nationally Uniform Body Of Law."

1. The FDIC's request that this Court create a uniform federal rule of decision concerning imputation defenses to attorney malpractice claims fails at the thresh-

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[23] *See also Texas Indus., Inc.* v. *Radcliff Materials, Inc.,* 451 U.S. 630, 646-47 (1981) (the task of resolving conflicting policy arguments, "regardless of the merits of the conflicting arguments, is a matter for Congress, not the courts"); *Halcyon Lines* v. *Haenn Ship Ceiling & Refitting Corp.,* 342 U.S. 282, 286 (1952) ("We think that legislative consideration and action can best bring about a fair accommodation of the diverse but related interests of these groups. The legislative process is peculiarly adapted to determine which of the many possible solutions to this problem would be most beneficial in the long run."); *cf. Bush* v. *Lucas,* 462 U.S. 367, 388-90 (1983) (refusing to add a "new judicial remedy" to remedies Congress has already provided as Congress is in a better position to evaluate and balance conflicting policy arguments).

old. This is because the FDIC itself relies on what it asserts is favorable California *state* law on the issue of the existence and extent of the duty of investigation that an attorney owes to its client. Thus, the FDIC does not genuinely seek "a nationally uniform body of law," *id.* at 728; rather, the only uniformity in the FDIC's position is its desire to prevail in all cases.

This Court's decisions emphasize that a federal agency's reliance on substantive state law on some issues "belie[s] [its] assertion that a federal rule . . . is needed to avoid the administrative burdens created by disparate state" laws. *Kimbell Foods,* 440 U.S. at 731-32; see also *id.* at 729-31; *United States* v. *Yazell,* 382 U.S. 341, 346, 357 (1966) (government's own use of state law on some issues is "intensely material" to rejection of government's request for uniform federal rule of decision on other issue); *cf. RFC* v. *Beaver County,* 328 U.S. 204, 209 (1946) (where part of regulatory scheme relies on state law, "assumption" that uniformity is necessary cannot be made). Here, at the FDIC's urging, the Ninth Circuit appeared to find in California law a unique duty of a lawyer to make a broad investigation for the benefit of his or her client into the very facts falsely represented to the attorney by the client. See Pet. App. 6a-9a. Such a duty, even if it exists under California law, which is doubtful,[24] is certainly a pro-plaintiff rule that goes well

[24] The Ninth Circuit's decision is contrary to the principles of the most analogous California decisions. *See Blain* v. *Doctor's Co.,* 222 Cal. App. 3d 1048, 1063-64, 272 Cal. Rptr. 250, 258-59 (1990) (a client may not sue an attorney for the consequences of the client's false statements); *Bily* v. *Arthur Young & Co.,* 3 Cal. 4th 370, 397-98, 404-06, 834 P.2d 745, 761, 766-67 (1992) (refusing to expand professional liability because benefits are dubious but increased costs and decreased availability of services are probable). It is also contrary to (1) generally recognized ethical standards, *see* A.B.A. Model Rules of Professional Conduct, Rule 2.1 cmt. (1983) ("A lawyer ordinarily has no duty to initiate investigation of a client's affairs"); *Fortson* v. *Winstead, McGuire, Sechrest & Minick,* 961 F.2d 469, 474 (4th Cir. 1992) (ABA's standard "permits an attorney to assume that the facts related to him by the client are accurate, so long as he has no knowledge

beyond any duty imposed by FIRREA, see *supra* pp. 27-28, applicable ethical rules, or the common law in other states, see *supra* p. 34 and note 24.[25]

that would raise suspicion"); *Stokes* v. *Lokken,* 644 F.2d 779, 783 n.3 (8th Cir. 1981) (ethical standards do not impose duty on attorney to investigate information supplied by client); and (2) the common law of sister states, *see, e.g., Milliner* v. *Elmer Fox & Co.,* 529 P.2d 806, 808 (Utah 1974) (dismissing action against attorney who prepared SEC filings: "As a general rule, an attorney is not required to investigate the truth or falsity of facts and information furnished by his client, and his failure to do so would not be negligence . . ."); *Hangman Ridge Training Stables, Inc.* v. *Safeco Title Ins. Co.,* 652 P.2d 962, 966 (Wash. Ct. App. 1982) (Attorneys do not have "an obligation to make extensive inquiries into [clients'] personal or financial conditions . . . . Otherwise, there would be no possible limit on the advice attorneys would be required to give."); *Friedman* v. *Dozorc,* 312 N.W.2d 585, 605-06 (Mich. 1981) ("A lawyer is entitled to accept his client's version of the facts and to proceed on the assumption that they are true absent compelling evidence to the contrary."); *Pacelli* v. *Kloppenberg,* 382 N.E.2d 570, 571 (Ill. App. 1978) (when an attorney does not have a "reason to question the honesty" of a fiduciary and agent of the client, the attorney has no duty of "investigation" regarding that fiduciary); *Bryan & Amidei* v. *Law,* 435 S.W. 2d 587, 593 (Tex. Civ. 1968) ("an attorney has a right, in good faith, to advise and act upon the facts which he gets from his client, and it is not his duty to go elsewhere for information").

[25] The Ninth Circuit's analysis demonstrates the hazards of mixing and matching state and federal law. The Ninth Circuit relied exclusively on interpretations of federal securities law as support for the duty it purported to find under California law. First, the Ninth Circuit relied on two outdated and inapposite district court decisions interpreting Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*. *See* Pet. App. 8a. Section 12 of the Securities Act is an inappropriate guide to a state common law suit by an issuer of securities against its lawyer because: (1) Lawyers whose involvement, as here, is "the performance of their professional services," are not proper Section 12 defendants. *Pinter* v. *Dahl,* 486 U.S. 622, 651 & n.27 (1988). (2) Section 12 defines duties between a purchaser of securities and a defendant, *see Pinter,* 486 U.S. at 641; Section 12 does not define any duties owing to a seller or issuer of securities, such as ADSB, *see, e.g., Glusband* v. *Fittin Cunningham Lauzon, Inc.,* 582 F. Supp. 145, 149-50 (S.D. N.Y. 1984) (receiver of issuer). *Cf. Bily,* 3 Cal. 4th at 396-98, 834 P.2d at 760-61 (emphasizing that tort liability requires breach

The FDIC thus seeks to mix and match (1) aspects of putatively favorable state law with (2) judge-made uniform federal rules of decision applicable to other issues whenever state law turns unfavorable. The result is a hybrid claim recognizable under neither California law nor federal law. See *supra* pp. 26-28. The FDIC seeks no uniformity of law, only a uniformity in results. This is exactly the kind of approach that *Kimbell Foods* and other cases forbid.

Nor is the government's heavy reliance on favorable state law limited to this case. The government routinely brings claims against attorneys, accountants, directors, and officers based on asserted breaches of state-law duties.[26] Indeed, the government principally uses local private law firms, not agency counsel or officials, both to investigate and litigate such claims. See *FDIC* v. *Jenkins*, 888 F.2d 1537, 1540 n.4, 1544-46 (11th Cir. 1989) (FDIC official concedes that the FDIC does not investigate institution's potential tort claims at time of federal takeover).[27] Ob-

of a duty owed to the particular plaintiff). (3) In certain respects, the rules imposed by Section 12 are broader than those that exist under the common law. *See Pinter*, 486 U.S. at 641 n.18, 647-48 n.23, 652.

Second, the Ninth Circuit selectively quoted from H. Bloomenthal, *Securities Law Handbook*, § 27.02, at 1096 (1990-91 ed.), omitting the portion that states Bloomenthal is merely repeating a "view" of the SEC expressed in a 1962 administrative release. *Id.* More recent authority from the SEC holds that an attorney may rely on information supplied by a client's officers unless the attorney has "knowledge" that the information is false. *In re Carter*, 1981 Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,167-68 (SEC 1981).

[26] The FDIC and the RTC have relied on state statutory causes of action, as well as favorable state common law. *See, e.g.*, Complaint ¶¶ 94-96, *FDIC* v. *Nathan*, No. H-91-2845 (S.D. Tex., filed Sept. 25, 1991) (Texas Deceptive Trade Practices Act); Complaint ¶¶ 82-84, *RTC* v. *Emerald Homes L.P.*, No. Civ-92-1785PHX-RMB (D. Ariz., filed Sept. 21, 1992) (Arizona RICO statute); Complaint ¶¶ 127-28, *RTC* v. *Dean*, No. Civ-92-030PHX-RCB (D. Ariz. filed Feb. 14, 1992) (Arizona illegal dividend statute).

[27] In this case, for example, the FSLIC and the FDIC have paid a California law firm over $8.1 million to investigate and

viously, these private law firms have an intimate familiarity with applicable state tort law, and its application creates no administrative burden for them. Because the government does not genuinely seek uniformity, the government can find no support in the first *Kimbell* factor.

2. Even if FDIC sought a "nationally uniform body of law," the interest asserted in this case would still be a minimal one because the "difference between the rules" followed in the states on imputation and the defenses available against a receiver "are insignificant in comparison with the similarities." *Kimbell Foods*, 440 U.S. at 732 n.28. California law requires imputation when "the agent is in fact acting for his principal in the transaction, even though he may have an opposing personal interest." *McKenney* v. *Ellsworth*, 165 Cal. 326, 329, 132 P. 75, 76 (1913). In *McKenney*, the president of a bank sold a note to the bank knowing that there had already been an offsetting payment. The president "conducted the affairs of the bank" and acted as both seller "and the agent who was consummating the purchase on behalf of the bank." *Id.* at 329-30, 132 P. at 76. When the receiver for the failed bank sued for payment of the note, the court upheld an imputation defense even though the president had benefited and the bank had lost money. *Id.*

California law requires imputation based on at least two sets of circumstances present in this case. First, California law requires imputation when the agents with knowledge are persons who "controlled the management, policies, and affairs of [the] corporation[]." *West American Finance Co.* v. *Pacific Indem. Co.*, 17 Cal. App. 2d 225, 228, 61 P.2d 963, 965 (1936). In *West American Finance*, the agents with knowledge owned a majority of the corporation's stock and controlled its activities. *Id.* They engaged in a series of fraudulent loans, purchases,

litigate claims, principally those against ADSB's owners and senior officers. E.R. 3123-24. Just in the two years 1991 and 1992, the FDIC and the RTC paid outside law firms over $1.5 billion. *See* Nat'l L.J., March 22, 1993, at 3.

and false book entries that caused "large financial losses" to the corporation. *Id.* at 229-33, 61 P.2d at 965-67. The court held that the knowledge of these controlling persons "of their own fraudulent transactions was imputed to the corporation itself, even though [they] were beneficially interested in the frauds so consummated, to the detriment of the corporation." *Id.* at 236-37, 61 P.2d at 969; accord *William* v. *Hasshagen*, 166 Cal. 386, 393, 137 P. 9, 12 (1913) (imputing knowledge of agent who controlled policy and management and holding that "it makes no difference that he took some personal benefit from the fraud"). The present case provides even stronger grounds for imputation under California law than did *West American Finance*. Here, Sahni and Day owned 100% of ADSB's stock and even the FDIC has stated that they had "complete control" of ADSB and its subsidiaries. *Supra* p. 2 and note 3. Sahni and Day had knowledge of all of the information petitioner was allegedly negligent in failing to uncover. See *supra* pp. 2-12.

Second, California law requires imputation for agents with responsibility for a particular transaction, even when they do not control the corporation as a whole. See, *e.g.*, *Rhinock* v. *Price*, 218 Cal. 403, 407, 23 P.2d 1014, 1016 (1933) (knowledge of car salesman who fradulently obtained possession of customer's car is imputed to dealership, despite salesman's adverse interest); *Maron* v. *Swig*, 115 Cal. App. 2d 87, 90-91, 251 P.2d 770, 772 (1962) (superintendent of building used his access to steal property from tenants); *State Sav. & Commercial Bank* v. *Winchester*, 25 Cal. App. 691, 695, 145 P. 171, 172-73 (1914) (secretary of bank). Here, the agents of ADSB who were responsible—both for the transactions that improperly inflated ADSB's reported net worth and for the later Wells Park and Gateway Center transactions on which petitioner worked—knew the very information that petitioner allegedly negligently failed to uncover. See *supra* pp. 2-12.

As applied to a case such as this, the law of imputation followed in California reflects fundamental principles of

fairness and proximate causation.[28] This is illustrated by the analogous case of *Flagg* v. *Seng*, 16 Cal. App. 2d 545, 60 P.2d 1004 (1936). In *Flagg*, a bankruptcy trustee sued outside professionals (auditors) for alleged negligence in failing to conduct a more diligent investigation to discover false records and improper transactions. The controlling directors of the failed corporations had known the true facts. *Id.* at 551, 60 P.2d at 1007. The court held that this knowledge demonstrated that nothing done by the outside professionals "had any causal relation to" the losses of the corporation. *Id.* Rather, the controlling directors "were not only not deceived by the audits and reports, but they had intentionally handled the transactions in such a manner as to make them appear on the books [falsely.]" *Id.* Accordingly, the judgment against the bankruptcy trustee was affirmed. *Id.* at 552, 60 P.2d at 1008.

Flagg and *McKenney* also demonstrate that under California law a successor such as a bankruptcy trustee or receiver is subject to an imputation defense. Indeed, under California law, "any defense, good against the original party, is good against the receiver." *People* v. *California Safe Deposit & Trust Co.*, 168 Cal. 241, 246, 141 P. 1181, 1183 (1914); accord *Allen* v. *Ramsay*, 179 Cal. App. 2d 843, 854, 4 Cal. Rptr. 575, 582-83 (1960).

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[28] Labels other than proximate causation have sometimes been given to a state-law imputation defense in this context, including lack of reliance. *See, e.g.*, *FDIC* v. *Ernst & Young*, 967 F.2d 166, 170 (5th Cir. 1992) (lack of reliance). Although the Ninth Circuit chose the label "estoppel" for the defense, the real basis for the defense is a failure of the plaintiff to prove the elements of its claim. That is, when wrongdoing by controlling owners, directors, or officers is imputed to the corporation, the corporation cannot assert injury to a legally protectible interest in a suit against a former outside professional to the corporation. *Cf. Blain* v. *Doctor's Co.*, 222 Cal. App. 3d at 1063-64, 272 Cal. Rptr. at 258-59. Of course, whether federal law displaces a state-law rule depends on the substance of the rule, not its label. *Cf. New York Times Co.* v. *Sullivan*, 376 U.S. 254, 269 (1964).

The rules applied in California on (1) imputation and (2) the applicability to a receiver of defenses available against its insolvent predecessor are well established throughout this country. To the best of our knowledge, every state to address the imputation issue posed by this case has adopted a rule consistent with California's—*i.e.*, that imputation exists when "the agent is in fact acting for his principal in the transaction, even though he may have an opposing personal interest," 165 Cal. at 329, 132 P. at 76—particularly when, as here, the agents exercised control over the corporation or the transactions at issue. State-by-state citations of such decisions are set forth in Appendix A hereto. Indeed, this Court in applying federal law to cases involving the fraudulent procurement of land from the United States has followed such a rule. See *Curtis, Collins & Holbrook Co.* v. *United States*, 262 U.S. 215, 224 (1923) (imputation applied even though agent "was violating his instructions" and the more land the agent fraudulently procured, "the more profit he would make"); *J.J. McKaskill Co. v. United States*, 216 U.S. 504, 515 (1910) (agents controlled corporation).

Similarly, in a pre-*Erie* case on appeal from the courts of the District of Columbia, *Armstrong* v. *Ashley*, 204 U.S. 272 (1907), a receiver of a lending company was held not entitled to recover because the knowledge of the company's agents who intentionally approved a fraudulent loan was "imputed to the company," in whose shoes the receiver stood. *Id.* at 283. The court held that when the defendants were not participants in and had no knowledge of the fraud—as is the case here—"[t]he fact that those agents committed a fraud cannot alter the legal effect of their acts or their knowledge with respect to the company." *Id.*

Armstrong also demonstrates, see also *supra* pp. 20-21, that this Court has followed the rule that, absent an express statutory exception, a receiver is subject to defenses available against its predecessor. This rule is also uni-

formly followed in the States. See, *e.g.*, 10 Am. Jur. 2d *Banks* § 764, at 727 (1963); see also *supra* p. 21, note 14.

In sum, the two rules of law sought by the FDIC—that loss to the corporation bars imputation even where the sole owners and management are acting for the institution and that a receiver is not subject to defenses based on its predecessor's wrongdoing—cannot be justified on grounds of uniformity. If anything, there already exists uniform opposition to these rules.

3. Even if applicable state law rules were more disparate, any virtues of uniformity would have to be balanced against the heavy burdens placed on the federal courts in creating a nationally uniform body of tort law. See *Wallis* v. *Pan American Petroleum Corp.*, 384 U.S. 63, 68 (1966) (Court should consider "the feasibility of creating a judicial substitute" for state law). The FDIC and its sister agency, the Resolution Trust Corporation (RTC), have asked the courts to create uniform federal rules of decision on a wide variety of issues in tort suits, including causation, mitigation, comparative fault, proportionate fault, the effect of settlements, and tolling principles applicable to statutes of limitations.[29] Indeed, the FDIC has candidly conceded in this Court that it seeks "articulation of uniform *rules* of federal law that protect federal receivers against claims and defenses that might have been successful against the institution." Petition for Certiorari, at 5, *FDIC* v. *Shrader & York*, (No. 93-651) (emphasis added). The government has even invoked federal common law in support of the creation of novel causes of action not recognized under applicable state law.[30]

[29] *See, e.g.*, *FDIC* v. *Cocke*, 7 F.3d 396, 400 (4th Cir. 1993); *FDIC* v. *Dawson*, 4 F.3d 1303, 1308-09 (5th Cir. 1993); *FDIC* v. *Ferguson*, 982 F.2d 404, 406-07 (10th Cir. 1991); *RTC* v. *Holland & Knight*, 832 F. Supp. 1528 (S.D. Fla. 1993); *FDIC* v. *Gantenbein*, 811 F. Supp. 593, 595-96 (D. Kan. 1992); *FDIC* v. *Cherry, Bekaert & Holland*, 742 F. Supp. 612, 613-15 (M.D. Fla. 1990); *FDIC* v. *Clark*, 1989 U.S. Dist. LEXIS 17556, at *15-*24.

[30] *See, e.g.*, Plaintiff's Supplemental Response to Defendants' Motion to Dismiss, filed Sept. 18, 1992, at 3, 7, *RTC* v. *Deloitte &*

If the FDIC and the RTC succeed in these arguments, the federal courts will be bogged down for years in determining which issues require uniform federal rules of decision, as well as what those rules should be. This prospect is intolerable both for the already strained federal courts and for the individuals affected by such rulings. *Cf. Kimbell Foods,* 440 U.S. at 739 n.42 (refusing to "[d]evelop[] priority rules on a case-by-case basis").[31]

B. Application Of State Law Would Not Frustrate Specific Objectives Of The Federal Program.

The FDIC has previously contended that state law defenses based on imputation frustrate its ability to obtain maximum recovery. Of course, such a rationale would apply to all state law defenses—indeed, to all the elements of the FDIC's *prima facie* case and even to the requirement of adequate factual proof. This Court has squarely rejected this kind of self-serving argument.

As the Court held in *Robertson* v. *Wegmann,* 436 U.S. 584, 593 (1978),

> a state [law] cannot be considered 'inconsistent' with federal law merely because the [state law] causes the plaintiff to lose the litigation. If success of the . . . action were the only benchmark, there would be no reason at all to look to state law, for the appropriate rule would then always be the one favoring the plaintiff, and its source would be essentially irrelevant.

Touche, (D. Colo.) (No. 92-C-408) (asserting federal common law tort of "spoliation of evidence").

[31] The principal case relied on by the FDIC, *D'Oench, Duhme & Co.* v. *FDIC,* 315 U.S. 447 (1942), is distinguishable concerning uniformity on at least three grounds. First, in *D'Oench,* the FDIC did not rely on state law for some issues and federal law for others. Second, because *D'Oench* was decided prior to promulgation of the Uniform Commercial Code, there was significant disparity in applicable state law concerning when a third party took a note subject to a borrower's secret agreement. *See id.* at 453, 455. Third, the issue in *D'Oench* was discrete and did not threaten to enmesh the federal courts in determining uniform federal rules of decision for a host of other issues.

United States v. *Yazell,* 382 U.S. 341, 348-49 (1966), further holds that the "more money" argument is no more persuasive simply because it is offered by the United States, explaining that the government's desire to recover money

> serves merely to present the question—not to answer it. Every creditor has the same interest in this respect; every creditor wants to collect. The United States, as sovereign, has certain preferences and priorities, but neither Congress nor this Court has ever asserted that they are absolute.

Kimbell Foods also rejected the government's "more money" argument, focusing on two important points. One was that the statutory schemes for the SBA and the FHA provided means other than displacing state law to protect federal financial interests. See 440 U.S. at 735-37. The other was that the statutory schemes embodied policy goals other than maximizing federal recovery of funds. Specifically, the statutes sought to encourage lending that otherwise might not occur. See *id.* at 735-36. The effects of a uniform federal rule of decision on these other policy goals was "difficult to foresee" and might "inhibit private lenders' extensions of credit to the very people for whom Congress created these programs." *Id.* at 739 & n.43. The Court properly refused to do what Congress had not done, *i.e.,* set the balance between the competing policy goals reflected in the statute by creating a uniform federal rule of decision overriding state law. See *id.* at 735 ("We believe that had Congress intended the private commercial sector, rather than taxpayers in general, to bear the risks of default entailed by these public welfare programs, it would have established a priority scheme displacing state law.").[32]

[32] The Court has previously recognized and applied the larger truth that:

> no legislation pursues its purposes at all costs. Deciding what competing values will or will not be sacrificed to the achievement of a particular objective is the very essence of legislative choice—and it frustrates rather than effectuates legislative

Both of the circumstances in *Kimbell Foods* are present in even greater force here. As in *Kimbell Foods*, the statute provides a number of mechanisms for protecting the federal treasury. These include: (1) Federal regulators periodically (now, annually) conduct an examination of the institution and its assets. See 12 U.S.C. §§ 1464(d)(1)(B), 1820(d). The examiners have complete access to the institution's employees, books, records, and documents. See *id.* § 1464(d)(1)(B)(ii). Indeed, the regulators can take testimony under oath and issue subpoenas. See *id.* § 1464(d)(1)(B)(v). As part of the examinations, the regulators are charged with evaluating the value of the assets of the institution and may order new appraisals or direct additional reserves as appropriate. See, *e.g.*, 12 C.F.R. §§ 563-17.1(a)(1), (b)(1); 563-17.2(b), (c) (1985); see also H.R. Rep. No. 330, 102d Cong., 1st Sess. 99 (1991) (examinations are "[o]ne of the keys to protecting the Federal deposit insurance funds . . ."). In this case, as the Ninth Circuit concluded, "FHLB examiners were investigating ADSB for two years prior to the takeover. The regulators were closely overseeing the thrift and had the ability, either independently or through FSLIC, to uncover the facts and notify ADSB of the discovery." *California Union Ins. Co.* v. *American Diversified Sav. Bank*, 948 F.2d 556, 565 (9th Cir. 1991). (2) The regulators can direct savings and loans to raise both additional capital and the ratio of capital to assets. See 12 U.S.C. § 1464(s). Such private capital "provid[es] a cushion against losses if the institution's condition deteriorates," thus reducing the chance of a loss being borne by the government. H.R. Conf. Rep. No. 222, 101st Cong., 1st Sess. 404 (1989). (3) The regulators can increase a savings and loan's insurance premium to reflect the risks that that institution's

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intent simplistically to assume that *whatever* furthers the statute's primary objective must be the law.

Rodriguez v. *United States*, 480 U.S. 522, 525-26 (1987) (per curiam) (emphasis in original).

activities pose to the insurance fund. See 12 U.S.C. § 1817(b)(1) (B)(i) and (ii). (4) If the condition of a savings and loan deteriorates or if it engages in improper practices, the regulators can limit asset growth, impose cease-and-desist orders, remove management or the directors, terminate federal insurance, or place the institution in conservatorship or receivership. See 12 U.S.C. §§ 1464(d)(2), 1818(a)(2), (b)-(e).

Nothing in this statutory scheme for protecting the federal treasury gives lawyers an affirmative role in carrying out that scheme. To the contrary, the scope of the statute only extends to a lawyer for the institution who "knowingly or recklessly" participates in specified misconduct causing injury to the institution. See 12 U.S.C. § 1813(u). Even then, the statutory remedies do *not* include giving the receiver an express cause of action for damages, divorced from the elements of state law.

Moreover, as in *Kimbell Foods*, the policy goals of the statutory scheme here extend far beyond protecting the federal treasury. In particular, federal legislation provides many economic incentives in order to encourage residential lending, the development of low and moderate-income housing, and the rejuvenation of distressed local real estate markets—all of which might not occur if purely market forces prevailed. See, *e.g.*, H.R. Conf. Rep. No. 222, *supra*, at 413, 417, 421, 429; H.R Rep. No. 54(I), 101st Cong., 1st Sess. 294, 307, 309, 328, 334, 415, 440, 444-46 (1989); see also *supra* pp. 3-4.

Increasing the exposure of lawyers to professional liability will as likely impede these statutory lending objectives. As described previously, *supra* pp. 29-30, many lawyers will cease to represent savings and loans altogether. Less risk-averse attorneys that continue to represent savings and loans may well be less likely to counsel against imprudent transactions. Alternatively, attorneys may become so intimidated that they recommend against even sound transactions at the slightest sign of innovation or risk. At

a minimum, attorneys will raise their fees. This alone may make otherwise profitable transactions uneconomical.[33]

Congress recognized that the expansion of lawyer liability—as with any expansion of liability—is not without its costs. Thus, when Congress addressed the issue of remedies for lawyer misconduct, Congress consciously enacted a provision that "limits the exposure" of lawyers. H.R. Rep. No. 54(I), *supra*, at 392; see *supra* pp. 27-28 and notes 20-21. There is accordingly no basis in the statute or otherwise for using federal comon law, in the purported pursuit of statutory objectives, to expand lawyer liability beyond the parameters that Congress found appropriate.

C. Creation Of A Uniform Federal Rule Of Decision Would Severely Disrupt Commercial Relationships Predicated On State Law.

Respect for federalism has caused this Court repeatedly to refuse to create a uniform federal rule of decision to govern an issue that falls within an area traditionally controlled by state law. See *United States* v. *Yazell*, 382 U.S. at 352 ("Both theory and the precedents of this Court teach us solicitude for state interests."); *United States* v. *Brosnan*, 363 U.S. at 242; *RFC* v. *Beaver County*, 328 U.S. 204, 210 (1946) (Court should apply state law to an issue that is "deeply rooted in state traditions, customs, habits, and laws"). The issue in this case falls squarely within two traditional areas of state law.

First, the case involves tort law. Tort law is, of course, among the most fundamental and traditional areas of state law. See *Erie R.R.* v. *Tompkins*, 304 U.S. 64, 78 (1938).

[33] Again, *D'Oench* is distinguishable. Both *D'Oench* and later decisions emphasize that *D'Oench* involved the borrower's knowing participation in a secret agreement. *E.g.*, *D'Oench*, 315 U.S. at 458-61; *Langley* v. *FDIC*, 484 U.S. 86, 92 (1987); *United States* v. *Yazell*, 382 U.S. at 354. No policy argument could be advanced in favor of such a hidden agreement. The federal interest underlying *D'Oench* is fully vindicated now by 12 U.S.C. § 1823(e). Neither § 1823(e) nor *D'Oench* applies to this case because there is no secret agreement here, nor any knowing participation by petitioner in any illicit conduct.

Second, the issue in this case concerns the regulation of lawyers and the lawyer-client relationship. Again, both history and this Court's precedents teach that the regulation of lawyers and the lawyer-client relationship is preeminently a matter of state law. See, *e.g.*, *Leis* v. *Flynt*, 439 U.S. 438, 442 (1979) (per curiam) ("Since the founding of the Republic, the licensing and regulation of lawyers has been left exclusively to the States and the District of Columbia within their respective jurisdictions. The States prescribe . . . the standards of professional conduct."). Indeed, in enacting FIRREA Congress expressly acknowledged the continuing role for state law in regulating savings and loan lawyers. See H.R. Rep. No. 54(I), *supra*, at 467.

Respect for state law is not merely an abstract preference here. Rather, this Court's deference to state law "is particularly strong in areas in which private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards." *Kamen* v. *Kemper Fin. Servs.*, 111 S. Ct. 1711, 1717 (1991).

Plainly, a number of private parties have entered a variety of legal relationships with the understandable expectation that state law would govern issues of lawyer liability—including defining the scope of duties and defenses between lawyers and their clients. Based on these reasonable expectations, petitioner and other lawyers have charged ordinary fees, not fees reflecting any premium for the unexpected expansion of professional liability sought by the FDIC.[34] Law firms also contracted for certain amounts of insurance coverage and, in turn, the insurers charged standard premiums—neither the levels of cover-

[34] *D'Oench* again is distinguishable. The law of negotiable instruments, unlike the law governing attorney liability, has long recognized a number of ways in which a transferee takes a claim against the borrower free of certain defenses. *See* 315 U.S. at 458-59. Here, in contrast, no legal tradition suggests that transferees of attorney malpractice claims may take greater rights.

age nor the premiums reflect the FDIC's expanded theories of liability.

It is manifestly unfair to change the applicable legal rules after the fact. As this Court's precedents recognize, the decision to change existing legal rules, especially those grounded in state law, is essentially legislative in nature. Even if the FDIC were correct that the current state-law rules on imputation and lawyer liability presented a serious policy problem, as Justice Harlan wrote for the Court in rejecting a strikingly similar argument:

> A wise solution of such a far-reaching problem cannot be achieved within the confines of a lawsuit. Until Congress otherwise determines, we think that state law is effective . . . .

United States v. *Brosnan*, 363 U.S. at 252.

State law is effective here. Under California law, the decision of the Ninth Circuit should be reversed.

CONCLUSION

The judgment of the Ninth Circuit should be reversed.

Respectfully submitted,

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January 13, 1994

APPENDIX A

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Wyoming	*American Nat'l Bank of Powell* v. *Foodbasket*, 497 P.2d 546, 547-48 (Wyo. 1972).

No. 93-489

In the Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS, PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE FEDERAL DEPOSIT INSURANCE CORPORATION

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QUESTION PRESENTED

The Federal Savings and Loan Insurance Corporation, acting as receiver for a failed federally insured savings institution, brought suit against a law firm for giving negligent legal advice to the institution before it went into receivership. The law firm seeks to defend the suit on the ground that the savings institution itself would have been barred from suit because the conduct of its wrongdoing officers (who retained the law firm) would have been imputed to it. The question presented is whether this wrongdoing is to be imputed to the receiver so as to bar it from pursuing claims against the law firm for damage caused to the bank's financial condition by the firm's professional malpractice.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-16a) is reported at 969 F.2d 744. The opinion of the district court (Pet. App. 17a-19a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on June 29, 1992. A petition for rehearing was denied on June 30, 1993. Pet. App. 22a. The petition for a writ of certiorari was filed on September 27, 1993, and was granted on November 29, 1993. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (FIRREA), as amended, are set forth in the appendix to this brief. App., *infra,* 1a-14a.

STATEMENT

1. This case comes to this Court on review of the court of appeals' decision reversing a grant of summary judgment to petitioner. In connection with the summary judgment motion, the parties entered into a joint stipulation of facts.[1] All inferences from those facts must be drawn in favor of the FDIC, the non-moving party.

The case arises out of the failure of American Diversified Savings and Loan Association (ADSB), a California-chartered, federally insured thrift instittuion. ADSB was also engaged in the acquisition, development and syndication of residential and commercial real estate. In a typical syndication, a subsidiary of ADSB would form a limited partnership, acquire one or more large real estate projects with funds provided directly or indirectly by ADSB, and then sell limited partnership units to individual investors. ADSB and its subsidiaries would derive income from these syndications in the form of interest charged on loans to the limited partnerships and in the form of various fees and commissions, charged to the limited partnerships for management, brokerage, and other services.

Ranbir Sahni served as ADSB's Chairman and Chief Executive Officer and owned 96% of its stock. Lester Day served as ADSB's President and owned the remaining 4% of the stock. During the time that the events at issue in this case occurred and for some time before, both Sahni and Day had "cooked the books" of ADSB in order to record sham profits that inflated ADSB's in-

[1] The Joint Stipulation can be found at C.A. Exc. of Rec. 127. We cite to the Stipulation by paragraph numbers.

come and to conceal its insolvency. ¶¶ 10, 11, 15, 16, 216. They also were taking over two million dollars in salaries, bonuses, and loans to firms in which they personally owned an interest. ¶¶ 36, 180, 183, 195.

In the period prior to April, 1985, Touche Ross & Co. was ADSB's auditor. By early April, 1985, Touche Ross had determined that ADSB's books improperly inflated the firm's assets and income. Touche Ross accordingly notified Sahni that corrections would have to be made. ¶¶ 41, 59, 60. On April 23, 1985, ADSB replaced Touche Ross with Arthur Young & Co. as its independent auditor, purportedly because Touche Ross's fees were too high. ¶¶ 64, 66. In early May, Touche Ross, despite having been replaced as independent auditor, nonetheless notified Sahni, the Federal Home Loan Bank Board (FHLBB), and Rogers & Wells (ADSB's attorneys at that time) that ADSB appeared to have a negative net worth. ¶ 67.

Although Arthur Young was able to complete an audited March 31, 1985, financial statement for an ADSB subsidiary, ADC Financial, it could not complete its audit of ADSB. By October, 1985, Arthur Young was reviewing whether a list of properties were being carried on ADSB's books at excessive values totalling approximately \$60 million. ¶ 124. That amount was far greater than ADSB's reported net worth as of June 30, 1985, or \$28 million. ¶ 126. James Miller, ADSB's chief financial officer, was aware of the existence of large accounting issues that could affect the solvency of ADSB. ¶¶ 55, 91, 122. Miller also knew that, since early 1984, ADSB's practices had begun to attract the concern of federal and state regulators. ¶ 37. In the second half of 1985, ADSB had come under increasing regulatory scrutiny from state and federal regulatory agencies, which took action designed to restrict the amount of ADSB's loans to its own subsidiaries or any other single borrower. ¶¶ 93, 164, 165, 170-175.

Among the syndications that ADSB had planned for 1985 were three called Hickory Trace, Wells Park, and Gateway Center, in all of which ADC Financial was to be the general partner. ¶¶ 104, 135, 146. Rogers & Wells was counsel to ADSB and its affiliates in connection with the Hickory Trace limited partnership, and Arthur Young was its auditor for that syndication. ¶ 105. A private placement memorandum (PPM) for the sale of limited partnership units in Hickory Trace was issued by an ADSB subsidiary on or about August 1, 1985, and was supplemented on September 1 and October 7, 1985. ¶ 106; see C.A. Exc. of Rec. 997-1660. The Hickory Trace PPM included financial statements for the limited partnership and ADC Financial. It did not, however, include a financial statement for ADSB itself. ¶ 109. In late September, Rogers & Wells advised ADSB that, since the financial health of ADSB was essential to the success of the project, the Hickory Trace offering could not close —*i.e.*, the prospective investors could not be admitted as limited partners—until the investors received audited financial statements for ADSB for the fiscal year ended June 30, 1985. ¶ 115. Since Arthur Young had been unable to complete those financial statements, the Hickory Trace investors' funds were returned to them on December 9, 1985, and the Hickory Trace offering was withdrawn. ¶ 118.

In September, 1985, ADSB retained petitioner to assist with the Wells Park and Gateway Center syndications, and it retained Coopers & Lybrand as auditors for those projects. Pet. App. 2a; C.A. Exc. of Rec. 158, 1666-1671. ADSB management did not disclose to Arthur Young, Touche Ross, Rogers & Wells, or any regulatory agency the existence of the Wells Park and Gateway Center offerings or its retention of petitioner; federal regulators did not learn of the offerings until eleven days before they were to close, on December 20, 1985, and did not learn that petitioner had been retained as counsel until after January 1, 1986. ¶ 149.

ADSB supplied petitioner with copies of the Hickory Trace PPM when petitioner was retained. ¶ 137. Petitioner prepared the PPM's for Wells Park and Gateway Center, which were issued to prospective investors on October 17 and November 15, 1985, respectively. ¶¶ 138-139, 148, 150; see C.A. Exc. of Rec. 1831-2157, 2166-2495. The PPMs "projected the image [of each of the syndications] as a well-run partnership whose general partner was experienced with similar limited partnerships that had been successful." J.A. 8, 13. They contained statements that ADC Financial's assets included a certificate of deposit with ADSB of almost $5 million and that "ADSB had informed ADC Financial that 'current regulations and circumstances would permit ADSB to provide [ADC Financial] and affiliates with funds projected to be needed by them from ADSB.' " J.A. 8, 13.

Both of the PPMs included the audited financial statement of ADC Financial as of March 31, 1985, which had been prepared by Arthur Young. Neither, however, included a financial statement for ADSB. ¶¶ 143, 160. Neither petitioner nor Coopers & Lybrand contacted Arthur Young with respect to the inclusion of the March 31, 1985, ADC financial statement, and Arthur Young was unaware that it was being included. ¶¶ 144, 161. In the course of preparing the PPMs, petitioner also did not communicate in any way with Miller (ADSB's chief financial officer), Touche Ross (ADSB's prior independent auditor), Rogers & Wells (ADSB's prior syndication counsel), or ADSB's federal or state regulators. ¶ 149.

Both the Wells Park and Gateway Center offerings closed on December 31, 1985. ¶¶ 145, 162. Prior to that time, ADSB had missed the deadline imposed by state regulators for completion of its June 30 audit, as well as two extensions of time. ¶ 169. Throughout the month of December, the state regulatory agency issued increasingly stiff restrictions on ADSB's activities.

¶¶ 170, 172. By December 20, 1985, the FHLBB had also imposed severe operating restrictions on ADSB. ¶ 175.

Finally, on February 14, 1986, the FHLBB declared that ADSB was insolvent and that ADSB had substantially dissipated its assets, in violation of legal requirements. FHLBB appointed the Federal Savings and Loan Insurance Corporation (FSLIC) as Conservator for ADSB. ¶¶ 200, 202. A financial statement for ADSB and its subsidiaries for that date showed a negative net worth of $398 million. ¶ 204. A few days later, FSLIC filed suit against Sahni and Day for, *inter alia,* breach of fiduciary duty, fraud, and (as to Sahni only) RICO violations. ¶ 206.

During 1986, FSLIC received a number of complaints from Wells Park and Gateway Center investors, who claimed that they had been misled by the PPMs they had received. Pet. App. 4a. Acting as conservator, FSLIC made a rescission offer to the investors in the two projects, all of whom accepted the offer and were repaid their investments in full. ¶¶ 211, 213-214. In accepting the rescission offer, the investors each assigned to FSLIC all claims of any nature arising from the offering. Pet. App. 4a-5a.

On June 3, 1988, FSLIC was appointed receiver for ADSB. ¶ 219. FDIC succeeded FSLIC as receiver on August 9, 1989. ¶ 221.

2. On May 12, 1989, FSLIC filed this suit against petitioner, charging that petitioner's representation of ADSB in connection with petitioner's preparation of the PPMs for the Wells Park and Gateway Center offerings had been negligent. The complaint alleged that petitioner, as "special securities counsel and special tax counsel" for the offerings, had "failed to exercise such skill, prudence and diligence" as "meets the standards of knowledge and skill of securities specialists." J.A. 17, 18. In particular, the complaint alleged that, "in the exercise of reasonable diligence," J.A. 11, 15, petitioner would have

discovered information concerning the insolvent financial condition of ADSB and its subsidiaries "as to which a reasonable person would attach importance" in deciding whether to invest in either the Wells Park or Gateway Center offerings. J.A. 10, 15. The negligence counts sought to recover damages caused to ADSB as a result of the rescinded offerings. J.A. 17, 18.

The district court granted summary judgment to petitioner, apparently reasoning that petitioner's only duty was to the investors in the rescinded offerings, whose investments had been refunded in full and who therefore had no further claim against petitioner. Pet. App. 17a-19a.

3. The court of appeals reversed. Pet. App. 1a-16a. The court's analysis proceeded in three distinct steps: (a) for purposes of summary judgment, petitioner breached a duty of care to its client, ADSB; (b) wrongdoing or knowledge of wrongdoing possessed by Sahni and Day should not be imputed to ADSB; and (c) even if such wrongdoing or knowledge were to be imputed to ADSB, it would not in any event be imputable to FDIC, which was acting as receiver "to protect the interests of third parties who were not privy to the bank's inequitable conduct." *Id.* at 14a-15a.

a. The court first rejected the district court's decision regarding petitioner's limited duty of care. Pet. App. 6a-9a. The court held that petitioner's client was ADSB. *Id.* at 8a. With respect to petitioner's duty to ADSB, the court noted that, under California law, "[p]art and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors." *Ibid.* That duty includes the duty "to make a 'reasonable, independent investigation to detect and correct false or misleading materials.'" *Ibid.* In this case, there was evidence that such an investigation would at least have required "[petitioner] to contact Arthur Young, Touche

Ross, and Rogers & Wells prior to signing and releasing the PPMs," which it did not do. *Id.* at 9a.

b. Given the "basic duty to give proper advice to the client who is asking the public to invest in its offerings," Pet. App. 9a, the court considered petitioner's argument that, because insiders of the failed institution (Sahni and Day) perpetrated a fraud, their wrongdoing must be attributed to the institution, which would then be estopped from suing. *Id.* at 10a-13a. Citing California decisions, the court observed that a corporation is "a distinct legal entity separate from its stockholders and from its officers," *id.* at 10a, and that the question thus reduced to "whether Sahni and Day's wrongdoing as corporate *officers* can appropriately be attributed to ADSB." *Id.* at 11a. The rule of law governing that situation was that "the knowledge acquired by the agent who is acting adversely to his principal will not be attributed to the principal," *ibid.* (quoting *Meyer v. Glenmoor Homes, Inc.*, 54 Cal. Rptr. 786, 800-801 (Cal. Ct. App. 1966)).

In applying this adverse interest principle to this case, the court relied (Pet. App. 11a-12a) on a trio of cases in which federal courts had confronted the same issue: *Schacht* v. *Brown*, 711 F.2d 1343 (7th Cir.), cert. denied, 464 U.S. 1002 (1983); *Cenco Inc.* v. *Seidman & Seidman*, 686 F.2d 449 (7th Cir.) (applying Illinois law), cert. denied, 459 U.S. 880 (1982); and *In re Investors Funding Corp. Sec. Litigation*, 523 F. Supp. 533, 540-541 (S.D.N.Y. 1980) (applying New York law). The rule that emerged from those cases was that "conduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit that corporation." Pet. App. 12a. Since "disaster, not benefit, accrued to ADSB through the malfeasance of" its officers, the court held that the insiders' wrongdoing should not be attributed to the institution under the adverse interest rule. *Ibid.* The court distinguished the key California cases cited by petitioner on the ground that they involved a liability that would have been imposed on "an innocent third party," a status that a tortfeasor like petitioner could not claim. *Id.* at 13a n.8. To grant a tortfeasor an immunity from suit at the expense of the innocent victim of the fraud would not "serve the objectives of tort liability" of "properly compensating the victims of the wrongdoing and deterring future wrongdoing." *Id.* at 12a.

c. Finally, the court held that, even if the wrongdoing of Sahni and Day "would be imputed to ADSB so that ADSB would be estopped from bringing this lawsuit," it ought not be imputed to the FDIC as receiver. Pet. App. 13a. The court observed that "federal, not state, law governs the application of defenses against FDIC," *ibid.*, and that, to the extent that state law provides inadequate recognition of the FDIC's unique role, it ought not be incorporated into federal law. *Id.* at 13a-14a. The court noted that the FDIC as receiver "was neither a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects," *id.* at 14a, and that the FDIC acts pursuant to "an intricate regulatory scheme designed to protect the interests of third parties who also were not privy to the bank's inequitable conduct," *id.* at 14a-15a. Accordingly, "imputing the bank's inequitable conduct to the receiver" in a situation like the present case would "frustrat[e]" the statutory scheme by "diminishing the value of the asset pool held by the receiver and limiting the receiver's discretion in disposing of the assets." *Id.* at 15a.

SUMMARY OF ARGUMENT

The complaint in this case alleged that petitioner failed to exercise the care commonly expected of professionals in its field, thus breaching a duty to ADSB, its client. The court of appeals applied state law in finding that the summary judgment record supported that allegation, the petition did not challenge that holding, and, in the present posture of this case, the basic allegation of malpractice must therefore be taken as true. Had petitioner committed a similar dereliction of duty in a context not involving fraud by its client's officers, petitioner would concededly be liable in damages for any injuries suffered by its client. Petitioner's basic contention is that it is nevertheless entitled to full immunity from tort liability because its negligence related to the fraudulent acts of its client's officers.

Virtually all jurisdictions, including California, generally hold a corporation liable for the knowledge of its officers, except when those officers are acting adversely to the interests of the corporation. As the court of appeals realized, the key question in this case is thus whether ADSB's officers Sahni and Day were acting for the benefit of—or adversely to—the interests of ADSB in hiding the bank's true financial condition. In our view, the court of appeals correctly decided that, because ADSB was insolvent at the time of petitioner's negligence, its fraudulent officers were necessarily acting adversely to the bank by prolonging that insolvency. As a result petitioner, which would have discovered the bank's insolvency had it acted with reasonable care, cannot now invoke the officer's wrongdoing as a defense to an action for harm caused by its own negligence.

We believe that this result follows from a sound application of generally accepted legal principles. But even if the law of a given jurisdiction were to support application of an imputation defense in the circumstances of this case, that defense nevertheless could not apply as a matter of federal common law. This case clearly arises under federal law and involves the rights of a federal agency engaged in an important nationwide program. The FDIC as receiver therefore stands in a fundamentally different position from a receiver protecting the interests of ordinary commercial creditors in a nonbanking corporation. Unlike the relationship between an ordinary commercial creditor and an ordinary corporation, the FDIC's relationship with an insured financial institution does not result from a consensual transaction, but from the application of a federal statute. Moreover, also unlike any ordinary commercial creditor, the FDIC's potential risk in insuring a given financial institution is in effect unlimited, amounting to many times the value of the stockholder's equity in the institution. Finally, the FDIC provides such insurance not for private profit, but for the public welfare and the nation's economic health. For all those reasons, the FDIC as receiver for an insolvent federally insured institution cannot be barred by insider wrongdong from recovering damages caused to an institution by a negligent law firm or accountant that had a duty to discover that insolvency.

In its brief on the merits, petitioner claims for the first time in this litigation that there is no room for a federal common law rule in this case because Congress has codified the rules applicable to professionals working for financial institutions. That contention is mistaken. In enacting recent banking legislation, Congress did modify and enlarge the FDIC's authority in a number of areas, while remaining entirely silent regarding the issues in this case. There is no basis for construing Congress's silence as an implicit directive to federal courts to stop applying federal common law to cases of this kind. It would turn the federal statute on its head to presume that, by strengthening the hand of the FDIC and other bank regulatory agencies to regulate the banking industry, Congress thereby implicitly limited the rights of the FDIC as receiver to recover for damages that insured institutions suffer at the hands of bank officers, directors, and professionals.

ARGUMENT

I. THE WRONGDOING OF ADSB'S INSIDERS DOES NOT BAR THE FDIC AS RECEIVER FROM PURSUING THIS ACTION FOR DAMAGES TO ADSB CAUSED BY PETITIONER'S NEGLIGENCE

Since the choice of federal common law depends in great part on the specific legal context, our argument that federal common law applies to this case proceeds in two steps. First, we analyze the precise issue presented by this case and the context in which recognition of a federal common law rule is sought. As we explain, the rule we believe governs this case follows from largely undisputed legal principles that do not vary widely among jurisdictions; the key precedents applying those principles to fact situations comparable to that here were relied upon by the Ninth Circuit and support its result in this case. According to those authorities, we think it clear that, where a professional retained by a federally insured financial institution commits malpractice that aggravates or prolongs the insolvency of the institution, the fact that the institution's management fraudulently tried to conceal the insolvency does not prevent the FDIC from recovering for the malpractice.

Second, we argue that this rule governs this case as a matter of uniform federal common law, even if a particular State's law might appear to be to the contrary. That is because, whatever state law may dictate for cases involving ordinary commercial entities and their creditors, the FDIC stands in a unique posture with respect to federally insured institutions.

A. The Wrongdoing Of ADSB's Insiders Would Not Be Imputed To ADSB Under Generally Accepted Common Law Principles

1. We begin with a statement of our theory of liability in this case. In the present posture of this case, it must be taken as true that, at the time petitioner participated in preparation of the Wells Park and Gateway Center private placement memoranda, a careful professional in

petitioner's position would have obtained information showing that statements in those memoranda were materially misleading. Specifically, a careful professional would have realized the necessity of contacting Touche Ross (ADSB's recently terminated independent auditor); Arthur Young (ADSB's current auditor, who had been unable to produce up-to-date ADSB financial statements and who was conspicuously given no responsibilities for the Wells Park or Gateway Center offerings); or James Miller (ADSB's chief financial officer, who was aware of ADSB's financial problems and who was working with Arthur Young to resolve the numerous problems with ADSB's audit). Perhaps most important, a careful professional would have contacted Rogers & Wells, ADSB's counsel, who was working on a contemporaneous offering that petitioner knew of and that was cancelled, and who was conspicuously not retained to work on the Wells Park and Gateway Center offerings. Had petitioner contacted those parties, it would have learned of ADSB's serious financial difficulties and of the misleading nature of the PPMs. In preparing the misleading PPMs without having taken any of those steps, petitioner "failed to exercise such skill, prudence and diligence" as "meets the standards of knowledge and skill of securities specialists," J.A. 17, 18, thus breaching a duty owed to ADSB.

Petitioner's negligence caused ADSB harm. First, had petitioner learned of ADSB's insolvency (or worse), it would have had a duty to inform ADSB's management about the facts it discovered. That in itself would perhaps have accomplished little, since Sahni and Day knew of, and were complicit in, the fraud that sought to conceal ADSB's insolvency. But petitioner, had it acted carefully, could have further advised ADSB's management of the consequences of going ahead with the offering without disclosing ADSB's true financial condition. As the court of appeals held, "[p]art and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow

from promulgating a false or misleading offering to investors." Pet. App. 8a. Warning ADSB of this potential liability might have caused ADSB to alter its decision to go ahead with the offerings. Had it done so, it would have saved the bank from incurring the substantial losses it suffered by reason of the aborted offering.

Second, had petitioner exercised due care and discovered the facts concerning ADSB's financial condition, and had Sahni and Day nonetheless persisted in attempting to proceed with the offerings, petitioner would have been obligated to take further actions to protect its client, ADSB. Going ahead with the offering in those circumstances could only have led to legal liability and increased costs for ADSB. Accordingly, due regard for ADSB's interests would have required petitioner to withdraw, rather than assisting in the fraud that Sahni and Day were committing. Such a withdrawal would have either killed—or at least delayed—the Wells Park and Gateway Center offerings, and would have thereby saved ADSB the costs of later rescinding them.

2. In the current procedural posture of this case, therefore, petitioner would be subject to tort liability in a suit by ADSB under general state law principles governing professional malpractice cases that are not in dispute. Petitioner contends, however, that it cannot be held liable. According to petitioner, since Sahni and Day committed the fraud that concealed the insolvency petitioner failed to discover, that fraud shoud be imputed to ADSB. As petitioner claims in explaining its imputation defense, "when wrongdoing by controlling owners, directors, or officers is imputed to the corporation, the corporation cannot assert injury to a legally protectible interest in a suit against a former outside professional to the corporation." Pet. Br. 39 n.28.[2] According to petitioner, if the "wrong-

[2] See also Pet. Br. 14 ("The issues before the court of appeals were whether the wrongdoing of Sahni and Day, and their knowledge of that wrongdoing, were to be imputed to ADSB, their

doing" of Sahni and Day were imputed to ADSB, petitioner could be held liable neither to ADSB nor to the FDIC as receiver for ADSB.

3. The court of appeals rejected petitioner's argument. In doing so, it relied in large measure upon In doing so, however, it relied in large measure upon widely accepted legal principles.[3] Thus, the court noted that "[i]t is fundamental * * * that a corporation is a distinct legal entity separate from its stockholders and from its officers." Pet. App. 10a (internal quotation marks omitted). Accordingly, although "the knowledge of a corporate officer within the scope of his employment is the knowledge of the corporation," the "knowledge acquired by the agent who is acting adversely to his principal will not be attributed to the principal." *Id.* at 11a.

Petitioner does not appear to dispute either of these general principles. See Pet. 10-11 (referring to "the

wholly owned corporation, and whether this defense applied to the FDIC as receiver.").

[3] It is not entirely clear to us whether the court of appeals was applying state law or federal common law to determine that the fraud of Sahni and Day may not be imputed to ADSB. On the one hand, the court relied on three non-California cases to guide its application of the general principles governing the area to the factual setting of this case. Pet. App. 11a-12a. On the other hand, despite the court's undoubted sensitivity to the choice of law issue (evidenced by its express choice of federal law in its alternative holding regarding the FDIC's special rights as receiver), it did not explicitly state that it was departing from California law with regard to this holding. To the contrary, the court cited California cases for the general legal propositions governing the area and carefully distinguished the California cases cited by petitioner. See Pet. App. 11a-13a nn.5, 7-8. The court also introduced its discussion by reference to "principles of corporate identity and agency law [that] preclude attribution, starting with the basic distinction between a corporation and its shareholders." Pet. App. 10a (citing California cases). It is our position that federal common law does govern this issue, but that the content of the federal common law rule corresponds to the rule that would independently be adopted by most jurisdictions.

nearly universal rule that the knowledge of a corporate officer is not imputed to the corporation where the agent is acting adversely to the principal"). Indeed, most of the California cases on which petitioner relies, see Pet. Br. 37-39, as well as the cases petitioner cites from other States, see Pet. Br. App. A, recite the same general principles.

4. The crux of the dispute in this case comes in applying these universal general principles—and in particular, the "adverse interest" rule—to a situation in which a *wrongdoer* is sued, not by a solvent corporation that might have profited from the misdeeds of corporate officers, but by the FDIC as receiver for injuries caused to an *insolvent* financial institution. Putting to one side the unique role of the FDIC (which we discuss at pp. 27-34, *infra*), the principal cases dealing with this issue are the three cases cited by the court of appeals —*Schacht* v. *Brown,* 711 F.2d 1343 (7th Cir.), cert. denied, 464 U.S. 1002 (1983), *Cenco Inc.* v. *Seidman & Seidman,* 686 F.2d 449 (7th Cir.), cert. denied, 459 U.S. 880 (1982), and *In re Investors Funding Corp. Sec. Litigation,* 523 F. Supp. 533, 540-541 (S.D.N.Y. 1980).

In *Cenco Inc.* v. *Seidman & Seidman,* the independent auditors of a corporation were sued by the corporation for failing to detect fraud by the top management of the corporation; no receivership or insolvency appears to have been involved. 686 F.2d at 451. The Seventh Circuit noted that "the question has never been the subject of a reported case." *Id.* at 454. Accordingly, the court applied general principles to determine the viability of the corporation's claim. The court observed that the beneficiaries of any judgment in the case would be the corporation's shareholders, who had either benefitted from the fraud or recovered on independent claims from the auditors, or who at least were responsible for electing the

officers who committed the fraud. *Id.* at 455. Because "the stockholders should not be allowed to escape all responsibility for such a fraud," *id.* at 456, the court held that their professional malpractice action could not go forward.

In *Schacht* v. *Brown,* a similar claim was brought by the liquidator of an insolvent insurance company. The insurance company's insolvency led the Seventh Circuit to distinguish *Cenco.* See 711 F.2d at 1347-1350. In *Schacht,* the only possible benefit of the fraud was "continuing [the corporation's] existence past the point of insolvency to the detriment of outside creditors and policyholders." *Id.* at 1348. That result merely "aggravated [the corporation's] insolvency" and inflicted "real damage * * * by the diminution of its assets and income." *Ibid.* The court observed that "[i]n no way can these results be described as beneficial to [the corporation]," *ibid.;* instead "the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability," *id.* at 1350. Finally, the court noted that, unlike in *Cenco,* the suit would serve the purposes of "properly compensat[ing] the victims of the wrongdoing, and * * * deter[ring] future wrongdoing," *id.* at 1348, since a recovery would inure to the benefit of the corporation's policyholders and creditors, not its stockholders, who stand last in line for recovery. *Id.* at 1348-1349.

The court in *Investors Funding* similarly analyzed the "adverse interest" test in a suit brought by a bankruptcy trustee of an investment firm. 523 F. Supp. at 540-541. Applying New York law, the court rejected the argument that "prolong[ing] [the corporation's] existence several years beyond its actual insolvency" benefitted the corporation. *Id.* at 541. As the court explained, "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." *Ibid.* Accordingly, if as a result of the fraud

the corporation's "financial situation was caused to deteriorate even further," its "prolonged artificial involvency" benefitted only the managers and controlling stockholders, not the corporation itself. *Ibid.*

The rule that emerges from three cases is that the actions of a fraudulent corporate officer whose fraud has the effect of artificially prolonging the life of an insolvent corporation are necessarily adverse to the primary interests of the corporation's creditors, who had no role in the fraud but were, instead, its primary victims.[4] That result obtains even if the actions were not adverse to the interests of the shareholders before insolvency, as in *Cenco*. Thus, in *McCandless* v. *Furlaud*, 296 U.S. 140, 158-160 (1935), this Court held that "[i]t was not within the power of the shareholders [of an insolvent corporation] to legalize * * * waste [by dominant officers/shareholders] to the detriment of" the corporation's creditors. As in this case, after insolvency the officer's fraud is adverse to the corporation, and the knowledge and

[4] The proposition on which the *Cenco/Schacht/Investors Funding* rule is based is a familiar one. This Court long ago explained that a "corporation is an entity, distinct from its stockholders as from its creditors." *Hollins* v. *Brierfield Coal & Iron Co.*, 150 U.S. 371, 383 (1893). When it becomes insolvent, "the equitable interest of the stockholders in the [corporation's] property * * * places the property in a condition of trust, first, for the creditors, and then for the stockholders." *Ibid.* Accord *McDonald* v. *Williams*, 174 U.S. 397, 403-404 (1899) ("The assets of the bank while it is solvent may clearly not be impressed with a trust in favor of creditors, and yet that trust may be created by the very fact of the insolvency and the trust enforced by a receiver as the representative of all the creditors."); Ernest L. Folk, III, *et al.*, *Folk on the Delaware General Corporation Law* § 141.2.12 (3d ed. 1993) ("[F]iduciary duties to creditors arise when one is able to establish the fact of insolvency" and those "fiduciary duties arise at the moment of insolvency, rather than upon the initiation of statutory proceedings.").

wrongdoing of the officer will accordingly not be imputed to the corporation.[5]

5. Petitioner does not directly take issue with the general validity and applicability of the adverse interest rule. Nor does it appear to quarrel with the fact that, in the circumstances of this case, the interests of the fraudulent officers of ADSB were adverse to the interests of the insolvent bank and its depositors. Relying primarily on cases dealing with commercial paper and similar transactions, petitioner asserts instead that under the law of California, as well as some 42 other jurisdictions, the wrongful actions of Sahni and Day should be imputed to ADSB even if the interests of those officers were adverse to the interests of the bank.

Petitioner's authorities for this proposition, however, address issues entirely different from those presented in this case. The leading case on which petitioner relies is

[5] Petitioner cites (Pet. Br. App. A) two malpractice cases that have not followed the *Cenco/Schacht/Investors Funding* rule. In *Seidman & Seidman* v. *Gee*, 625 So. 2d 1 (Fla. Dist. Ct. App. 1992) (per curiam), a Florida intermediate appellate court erroneously imputed a fraudulent agent's knowledge to a corporation, in a case involving a suit for malpractice brought by the liquidator of an insolvent insurance company; as *Schacht* v. *Brown* makes clear, that result was incorrect. In *Stratton* v. *Sacks*, 99 B.R. 686, 694 (D. Md. 1989), aff'd, 900 F.2d 255 (4th Cir. 1990) (Table), a federal court applying Maryland law applied the doctrine of contributory negligence to bar a negligence action by the trustee of a bankrupt mortgage company against an accounting firm. The court stated that "it is not necessary * * * to determine whether the fraud of [the mortgage company's dominant shareholder] and other officers can be imputed to the corporation." 99 B.R. at 694. After the trustee failed to advance any theory of causation, see 99 B.R. at 695-696, the court did decide that, on the facts of that case, the accounting firm's negligence had failed to cause any damage. *Id.* at 696. But that conclusion provides no support for petitioner's imputation argument. Indeed, the court entirely ignored *Schacht* and *Investors Funding*, and it cited *Cenco* only in connection with its discussion of causation and other issues. See 99 B.R. at 692 n.6, 696.

McKenney v. *Ellsworth*, 132 P. 75 (Cal. 1913). In that case, an individual made a $7,500 note payable to the president of a bank, and later made a $5,000 payment on the note. The bank president endorsed the note to the bank without noting the payment on it, in connection with a fraudulent transaction he had undertaken himself. The bank's receiver subsequently sued the maker for the entire $7,500. The case turned not on whether the bank officer's interests were adverse to the bank, but on whether the bank was a holder in due course—*i.e.*, whether it had taken the note without notice of the defense of payment. The court held that it was not a holder in due course, since the bank president had full knowledge of the payment at the time the bank received it. 132 P. at 77.[6]

Virtually all of petitioner's other cases similarly involve a negotiable or similar instrument sold to a bank or other corporation by an officer who had defrauded the innocent maker. For example, of the five other California cases cited, Pet. Br. 37-38, four involved that fact pattern.[7] And of the other 38 published decisions cited

[6] The cases from this Court cited by petitioner (Pet. Br. 40) are on all fours with *McKenney*. See *Curtis, Collins & Holbrook Co.* v. *United States*, 262 U.S. 215, 224 (1923); *J.J. McCaskill Co.* v. *United States*, 216 U.S. 504, 515 (1910); *Armstrong* v. *Ashley*, 204 U.S. 272, 283 (1907). All of them imputed a fraudulent corporate official's knowledge to the corporation, where the dispute was between the corporation and an innocent third party who had no connection to the fraud. None of them involved a tort suit against a third party wrongdoer, as does this case.

[7] *Williams* v. *Hasshagen*, 137 P. 9, 12 (Cal. 1913); *State Sav. & Commercial Bank* v. *Winchester*, 145 P. 171, 172-173 (Cal. Dist. Ct. App. 1914); *Rhinock* v. *Price*, 23 P.2d 1014, 1016 (Cal. 1933). The fifth case, *West American Fin. Co.* v. *Pacific Indem. Co.*, 61 P.2d 963, 965 (Cal. Dist. Ct. App. 1936), involved a variation, where a dishonest corporate official took out a fidelity bond on behalf of the corporation for his own dishonesty; the court held that the corporation could not collect on the bond. In all of those cases, the dispute was whether an innocent third party (the obligee on the commercial obligation or the surety firm) should bear the loss created by the corporation's dishonest officer.

in petitioner's Appendix A in which the court imputed an officer's knowledge to a corporation,[8] 31 of them arose in similar commercial paper or commercial transaction contexts, involving the allocation of loss between a wholly innocent third party and a bank or other corporation whose officer committed a fraud.[9] Five of the cases arose

[8] The Appendix to petitioner's brief cites 42 published decisions, but four of them do not appear to be relevant to petitioner's argument or to any other issue in this case. See *California Consol. Mining Co.* v. *Manley*, 81 P. 50, 53 (Idaho 1905) (alter ego doctrine); *Merchants Nat'l Bank & Trust Co.* v. *H.L.C. Enters., Inc.*, 441 N.E.2d 509, 514 (Ind. Ct. App. 1982) (notice given to husband as shareholder of corporation can constitute notice given to wife, under certain circumstances); *Capital Bank & Trust Co.* v. *Broussard Paint & Wallpaper Co.*, 198 So. 2d 204, 209 (La. Ct. App. 1967) (involving primacy of mechanic's lien as against purchase money mortgage); *Yager Pontiac, Inc.* v. *Fred A. Danker & Sons, Inc.*, 343 N.Y.S.2d 209, 212 (N.Y. App. Div. 1973) (imputnig actions of agent to principal, with no issue of adverse interest), aff'd mem., 356 N.Y.S.2d 860 (N.Y. 1974).

[9] Twenty-seven of the 38 cases involved commercial paper transactions of precisely the same pattern, and raising precisely the same issue, as *McKenney*. See *Tatum* v. *Commercial Bank & Trust Co.*, 69 So. 508, 512-513 (Ala. 1915); *Matanuska Valley Bank* v. *Arnold*, 223 F.2d 778, 781 (9th Cir. 1955) (applying Alaska law); *Hughes* v. *Riggs Bank*, 239 P. 297, 298 (Ariz. 1925); *Bowen* v. *Mt. Vernon Sav. Bank*, 105 F.2d 796, 799 (D.C. Cir. 1939); *Morris* v. *Georgia Loan, Sav. & Banking Co.*, 34 S.E. 378, 383 (Ga. 1899); *First Nat'l Bank of Monmouth* v. *Dunbar*, 9 N.E. 186, 188 (Ill. 1886); *Nissen* v. *Nissen Trampoline Co.*, 39 N.W.2d 92, 96-97 (Iowa 1949); *Supreme Petroleum, Inc.* v. *Briggs*, 433 P.2d 373, 378-379 (Kan. 1967); *Megunticook Nat'l Bank* v. *Knowlton Bros.*, 135 A. 95, 97 (Me. 1926); *Tremont Trust Co.* v. *Noyes*, 141 N.E. 93, 98 (Mass. 1923); *National Turners Bldg. & Loan Ass'n* v. *Schreitmueller*, 285 N.W. 497, 499 (Mich. 1939); *Sussel Co.* v. *First Fed. Sav. & Loan Ass'n*, 238 N.W.2d 625, 628 (Minn. 1976); *First Nat'l Bank of Morristown* v. *C.W. Leeton & Bro.*, 95 So. 445, 448 (Miss. 1923); *Newco Land Co.* v. *Martin*, 213 S.W.2d 504, 511-512 (Mo. 1948); *State* v. *American State Bank of Aurora*, 187 N.W. 769, 770-771 (Neb. 1922); *Le Duc* v. *Moore*, 15 S.E. 888, 889 (N.C. 1892); *Dewey* v. *Lutz*, 462 N.W.2d 435, 443 (N.D. 1990); *First Nat'l Bank of New Bremen* v. *Burns*, 103 N.E. 93, 96 (Ohio 1913); *Wood & Co.* v. *State*, 80 P.2d 261, 264 (Okla. 1938);

in slightly different contexts, but appear to involve the same legal principles.[10] Petitioner cites only two cases that appear to present issues similar to this case, where a

Citizens' Nat'l Bank v. *Speck*, 164 A. 810, 811-812 (Pa. 1933); *Cook* v. *American Tubing & Webbing Co.*, 65 A. 641, 654-655 (R.I. 1905); *First Nat'l Bank of West Minneapolis* v. *Harvey*, 137 N.W. 365, 369 (S.D. 1912); *Mays* v. *First State Bank*, 247 S.W. 845, 846 (Tex. Comm'n App. 1923); *Evona Inv. Co.* v. *Brummitt*, 240 P. 1105, 1111 (Utah 1925); *State Bank of Pamplin* v. *Payne*, 159 S.E. 163, 165 (Va. 1931); *Knobley Mountain Orchard Co.* v. *People's Bank of Keyser*, 129 S.E. 474, 475-476 (W. Va. 1925); *American Nat'l Bank of Powell* v. *Foodbasket*, 497 P.2d 546, 547-458 (Wyo. 1972). Four additional cases involved similar issues, but the courts declined to impute knowledge in those cases either because the third party was complicit in the fraud, because the individual who committed the fraud was not an agent of the corporation at all, or because of some other factual peculiarity. See *Vail Nat'l Bank* v. *Finkelman*, 800 P.2d 1342, 1345 (Colo. Ct. App. 1990) (agent acting in individual capacity, not within scope of authority); *Saratoga Inv. Co.* v. *Kern*, 148 P. 1125, 1128 (Or. 1915) (refusing to impute knowledge because third party seeking benefit of defense may have conspired in fraud); *Milwaukee Acceptance Corp.* v. *Dore*, 168 N.W.2d 594, 598 (Wis. 1969) (party who committed fraud not agent of party seeking to enforce note); see also *Little Red River Levee Dist. No. 2* v. *Garrett*, 242 S.W. 555, 557 (Ark. 1922) (fraudulent agent worked for both parties).

[10] See *Bates* v. *Cottonwood Cove Corp.*, 441 P.2d 622, 624 (Nev. 1968) (whether corporation is liable for salaries paid to employee who falsely stated he had license required for job, where corporate official knew statement was false); *Ross Systems* v. *Linden Dari-Delite, Inc.*, 173 A.2d 258, 263 (N.J. 1961) (liability of franchisor to innocent franchisee for fraud of franchisor's representative); *Crystal Ice Co.* v. *First Colonial Corp.*, 257 S.E.2d 496, 498 (S.C. 1979) (priority contest where agent of both mortgagees fraudulently recorded later mortgage one minute earlier than purchase money mortgage); *Post* v. *Maryland Casualty Co.*, 97 P.2d 173, 176 (Wash. 1939) (liability of bond company on fidelity bond that fraudulent corporate officer acquired to insure against his own fraud). In the one case with facts somewhat analogous to this case, *Griffith Motors, Inc.* v. *Parker*, 633 S.W.2d 319, 323 (Tenn. Ct. App. 1982), the court correctly *refused* to impute the knowledge of a corporation's agent to the corporation, in a suit for malpractice brought by the corporation against its accounting firm for failing to uncover the fraud of the corporation's business manager.

defendant sought to avoid liability for *wrongful* conduct that caused harm to an *insolvent* corporation. See note 5, *supra*.

The commercial instrument cases on which petitioner relies have nothing to do with the outcome here. All of petitioner's cases involved an *innocent* third party and a corporation whose employee or agent had participated in a fraud while acting within the scope of his employment. In all of them, the party being asked to bear the loss caused by fraud is a third party (typically someone who had borrowed money from a bank) who had no duty to the corporation of any kind, who committed no tort, and whose entirely innocent conduct caused no injury to the corporation. In that setting, the courts understandably impose the risk of loss on the corporation. As the court of appeals explained, "[c]ases where innocent victims of an agent's wrongdoing sue the principal are inapposite in this context." Pet. App. 13a n.8.[11]

[11] Petitioner also briefly advances the independent argument that there can be no causation when the management of the institution was complicit in the fraud. See Pet. Br. 38-39. The primary authority on which petitioner relies for its causation argument is *Flagg* v. *Seng*, 60 P.2d 1004 (Cal. Dist. Ct. App. 1936). Just as petitioner's commercial law authorities concerning imputation have nothing to do with tort principles of causation, *Flagg* has nothing to do with petitioner's primary authorities concerning an imputation defense. In *Flagg*, the intermediate state appellate court upheld a judgment in favor of an accounting firm accused of committing malpractice against an insolvent corporation. The court strongly suggested that there had been no negligence. See 60 P.2d at 1006. But the court rested its decision on the fact that "it in no way appears that any discovery [the accounting firm] might have made would have affected the result." 60 P.2d at 1008. That is because the faulty practice "pursued by the directors [of the corporation] was followed on the advice of their attorneys, and * * * no such blame can be attached to [the accounting firm], under the circumstances here appearing, as would justify a reversal of the judgment." 60 P.2d at 1008. The fact that the accounting firm did not cause any injury on the particular facts present in *Flagg* does not suggest that petitioner caused no injury in the very different circumstances of this case. In all events, the allegations of causation here must be taken as true on a motion for summary judgment.

Indeed, the courts that discuss the rationale behind petitioner's cases make the governing principles quite clear. The question is said to be whether "one of two innocent persons [the corporation or the maker of the note] must suffer because of the fraudulent conduct of a third person [the corporate officer]. *First Nat'l Bank of Morristown* v. *C.W. Leeton & Bro.*, 95 So. 445, 448 (Miss. 1923). The courts have recognized that, in those circumstances, the "loss or suffering should fall upon the one who by his acts has clothed the third party with the power to commit the fraud." *Ibid.*[12] The fact that the third

[12] See also *Crystal Ice Co.* v. *First Colonial Corp.*, 257 S.E.2d at 498 ("agent's fraud cannot alter the effect of his knowledge to his principal *with respect to third persons who had no connection with the fraud*") (emphasis added); *Ross Systems* v. *Linden Dari-Delite*, 173 A.2d at 263 ("though the agent may have deceived the principal as well as the victim, since the principal placed the agent in the position where he had the power to perpetuate the wrong, the principal rather than the *innocent third party* should bear the loss") (emphasis added); *Post* v. *Maryland Casualty Co.*, 97 P.2d at 177 (adverse interest exception to rule of imputed knowledge "has no application where the corporation seeks to enforce the benefit of a fraud perpetrated by its officers on a third person" because "the exception * * * is not a vehicle for the consummation of fraud"); *State Bank of Pamplin* v. *Payne*, 159 S.E. at 166 ("[H]owever much at fault the defendants were in leaving their blank notes with the bank cashier, and giving him limited authority to fill in the blanks, certainly they are no more at fault than the bank was in accrediting the cashier as its trusted agent, and thereby affording him the opportunity to commit the fraud upon the defendants."); *Hughes* v. *Riggs Bank*, 239 P. at 299 ("We realize that any solution of this case must work hardship on an innocent party, but when one of two innocent persons must suffer, it is but just that the one whose agent is responsible for the act which fixes the loss should bear the burden."); *National Bank of San Mateo* v. *Whitney*, 183 P. 789, 791 (Cal. 1919) (assuming both plaintiff corporation and defendant maker of note to be "equally *innocent of wrong*," loss "resulted from the fact that the plaintiff had in its employment in a position of trust and confidence a dishonest employee") (emphasis added); *Tatum* v. *Commercial Bank & Trust Co.*, 69 So. at 512 (knowledge will be imputed "where the corporation has no other agency or representative in the matter, and the party asserting the knowledge or notice on the part of the corporation *is guilty of no negligence or fault in the transaction*") (emphasis added).

party is "not guilty of fraud or deceit *or wrongdoing of any kind*" is ordinarily seen as crucial to finding the corporation liable. *State* v. *American State Bank of Aurora*, 187 N.W. 769, 770 (Neb. 1922) (emphasis added). And the fact that the corporation itself has actually benefitted from the fraud is an important factor in refusing to permit it to impose a loss on the innocent third party.[13]

6. Those same principles lead to precisely the opposite conclusion here. Petitioner here is a wrongdoer, not an innocent third party to a consensual commercial transaction. The FDIC's suit against petitioner thus does not involve any attempt to impose the burden of a loss occasioned by fraud on an innocent third party to the transaction; it involves instead the imposition of liability on a negligent tortfeasor for losses caused by its lack of due care. Indeed, the innocent party in this case is not petitioner, but the insolvent ADSB and those with a primary interest in it—the FDIC and the other parties whose interests the FDIC represents. See 12 U.S.C. 1821(d)(2)(A)(i) (Supp. IV 1992). Accordingly, the

[13] See, *e.g.*, *Dewey* v. *Lutz*, 462 N.W.2d at 443 (imputation of insider's knowledge to corporation in part because "the Bank benefited from the fraudulent and deceitful scheme"); *American Nat'l Bank of Powell* v. *Foodbasket*, 497 P.2d at 548 ("if the principal * * * seeks to retain the benefits of the transaction, he is charged with the agent's knowledge"); *Newco Land Co.* v. *Martin*, 213 S.W.2d at 512 (party to whom knowledge sought to be imputed "in retaining the benefits of [the fraudulent acts] ratifies them"); *Atlantic Cotton-Mills* v. *Indian Orchard Mills*, 17 N.E. 496, 502 (Mass. 1888) (where "the person to whose benefit the fraud will inure seeks after knowledge of the fraud to avail himself of that act, *and to retain the benefit of it*, he must be held to * * * be chargeable with the knowledge of it, *so far at least as relates to his right to retain the benefit so secured*") (emphasis added).

equitable principles that require the corporation to bear the loss in petitioner's commercial paper cases lead to exactly the opposite conclusion here.

As discussed below, see pp. 28-31, *infra*, state courts only rarely have the opportunity to address situations comparable to that in this case, since bankruptcy and banking insolvency cases are ordinarily litigated in federal court. But when the state courts do address the issue, they almost uniformly adopt the *Cenco/Schacht/Investors Funding* rationale and refuse, because of the adverse interest rule, to impute the wrongdoing of bank officers to an insolvent bank.

For example, petitioner cites the Minnesota Supreme Court's decision in *Sussel Co.* v. *First Fed. Sav. & Loan Ass'n*, 238 N.W.2d 625 (Minn. 1976), which stated the general imputation principles applicable to a solvent partnership. But the Minnesota Supreme Court later decided *Bonhiver* v. *Graff*, 248 N.W.2d 291 (Minn. 1976), in which a state receiver for an insolvent insurance company sued the company's former accountant for malpractice in failing to uncover a fraud committed by corporate insiders. In response to a claim exactly parallel to that advanced by petitioner in this case, the court held that:

> [w]hether or not the company would be precluded from bringing this suit (the company was the victim of the fraud, and not the perpetrator), '[t]he receiver represents the rights of creditors and is not bound by the fraudulent acts of a former officer of the corporation.'

Id. at 296. Similarly, petitioner cites *Yager Pontiac, Inc.* v. *Fred A. Danker & Sons, Inc.*, 343 N.Y.S.2d 209 (N.Y. App. Div. 1973), aff'd mem., 356 N.Y.S.2d 860 (N.Y. 1974), for the application of the adverse interest test under New York law. But the federal district court in *Investors Funding* later applied New York law in the context of a corporation whose insolvency was artificially

prolonged by insiders' fraud to hold that the insiders' knowledge would *not* be attributed to the corporation.[14]

B. Principles Of Federal Common Law Bar Imputation Of The Wrongdoing Of ADSB's Insiders To The FDIC As Receiver

As we have explained above, the court of appeals' holding that the costs occasioned by petitioner's negligence should not be borne by the innocent depositors and other creditors of ADSB represents a sound application of generally accepted legal principles. In addition, those same legal principles constitute governing rules of federal common law that are applicable when FDIC acts as receiver for an insolvent depository instittuion that it has insured.[15]

[14] In addition, compare *Bates* v. *Cottonwood Cove Corp.*, 441 P.2d at 624 (cited by petitioner for the application of the adverse interest test in Nevada) with *Henderson* v. *Buchanan*, 52 B.R. 743, 772 (Bankr. D. Nev. 1985) (holding under Nevada law that trustee of insolvent corporaiton is not estopped from recovering for breach of fiduciary duty of corporation's directors even if corporation itself would be), judgment as to other claims rev'd in part, 131 insolvent corporation is not estopped from recovering for breach B.R. 859 (D. Nev. 1990), bankruptcy court judgment as to those claims affirmed, 985 F.2d 1021 (9th Cir. 1993); and compare *Saratoga Inv. Co.* v. *Kern*, 148 P. at 1128 (cited by petitioner for the application of the adverse interest test in Oregon) with *American Timber & Trading Co.* v. *Niedermeyer*, 558 P.2d 1211, 1221 (Or. 1976) (holding that equitable defenses good against majority stockholder/participant in wrongdoing not available against liquidator of insolvent corporation).

[15] Petitioner objects (Pet. Br. 36) to what it characterizes as FDIC's effort to "mix and match" a state cause of action with a federal rule of decision applicable to the imputation issue. Such "mixing and matching" is inevitable, of course, because federal common law frequently adopts state rules of decision. There is no presumption, however, that the use of a state cause of action requiries that state law apply to all elements of the case. In *Boyle* v. *United Technologies Corp.*, 487 U.S. 500, 512 (1988), for instance, the Court applied federal common law to supply a defense to a cause of action otherwise governed by state law, explaining

1. In *United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715, 726 (1979), this Court held that "federal law governs questions involving the rights of the United States arising under nationwide federal programs." Accord *Kamen* v. *Kemper Fin. Servs.*, 111 S. Ct. 1711, 1717 (1991). This case arises under such a program, and petitioner does not argue to the contrary. As the Court explained in *Kimbell,* however, "[c]ontroversies directly affecting the operations of federal programs, although governed by federal law, do not inevitably require resort to uniform federal rules." 440 U.S. at 727-728. The Court outlined three considerations in determining "[w]hether to adopt state law or to fashion a nationwide federal rule." *Id.* at 728. First, "federal programs that by their nature are and must be uniform in character throughout the Nation necessitate formulation of controlling federal rules." *Ibid.* (internal quotation marks omitted). See, *e.g., Clearfield Trust Co.* v. *United States,* 318 U.S. 363, 366-367 (1943). Second, "[a]part from considerations of uniformity," a court should "fashion special [federal] rules" where "application of state law would frustrate specific objectives of the federal programs." 440 U.S. at 728. Finally, the decision whether to fashion a federal rule should also take into account "the extent to which application of a federal rule would disrupt commercial relationships predicated on state law." *Id.* at 729.

2. Because state courts rarely or never have the opportunity to address the distinctly federal interests at stake in cases like this, there is a substantial need for a uniform federal rule. As petitioner's cases make clear, the principles underlying the state law imputation defense

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that it is frequently the case that "the conflict [between state law and federal objectives] is more narrow, and only particular elements of state law are superseded." *Id.* at 508 (citing *United States* v. *Little Lake Misere Land Co.*, 412 U.S. 580, 595 (1973), and *Howard* v. *Lyons*, 360 U.S. 593, 597 (1959)). See also *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447 (1942); *Deitrick* v. *Greaney*, 309 U.S. 190 (1940).

have largely been developed by state courts in the course of ordinary commercial litigation involving commercial paper and similar instruments and solvent financial institutions and entities. It is reasonable for a federal court to presume that those rules fully take into account the various interests at stake in that type of litigation. Accordingly, as this Court noted in *Kamen* v. *Kemper Fin. Servs., Inc.*, especially where "private parties have entered legal relationships with the expectation that their rights and obligations would be governed by state-law standards," there is thus a "presumption that state law should be incorporated into federal common law." 111 S. Ct. at 1717.

In this case, however, state law necessarily provides a perilous guide. State courts—which have limited opportunity to adjudicate cases involving insolvency in any event—very rarely have the opportunity to consider the unique considerations applicable to suits brought by the FDIC acting as receiver for insolvent financial institutions. See 12 U.S.C. 1819(b)(2)(B) (Supp. IV 1992) (FDIC's right to remove state court suits to federal court).

Unlike an ordinary commercial creditor, the FDIC does not become a creditor of a depository institution as a result of a consensual transaction. An ordinary commercial enterprise determines whether or not to extend credit to a customer and, if so, how much credit to extend, based upon an assessment of the customer's creditworthiness, including, where desirable, a judgment about the integrity of the customer's management. By contrast, federal statutes and regulations dictate the FDIC's choice of "customers," the amount of insurance it will underwrite, and the terms on which it will issue that insurance. See 12 U.S.C. 1814-1818, 1821(a) (1988 & Supp. IV 1992); see also 12 C.F.R. Pts. 303, 307, 312, 330.[16]

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[16] Although FDIC retains very substantial power to regulate insured institutions and to determine whether to insure an institu-

Unlike an ordinary commercial creditor, the FDIC's financial exposure with respect to a given institution is also effectively both unlimited and much greater than the exposure of the stockholders of the institution.[17] Under present federal standards, an insured thrift must maintain its capital at a level of approximately 5% of its assets, most of which are derived from deposited funds.[18] By contrast, the FDIC insures most of the deposits of the institution up to a level of $100,000 per account. Even with respect to an institution that fully satisfies regulatory capital requirements the FDIC's exposure to loss may therefore be twenty times that of the institution's stockholders. That level of exposure is much greater than the level that would be acceptable to an ordinary commercial creditor. As events in recent years have demonstrated, the risks underwritten by the FDIC, and through the FDIC by the taxpayers of the United States, are all too likely to materialize.

Finally, unlike ordinary commercial creditors, the FDIC insures deposits in order to stabilize and maintain public confidence in the nation's banking system—a goal that is of crucial importance to the welfare of the general public and the health of the national economy. Indeed, among

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tion, the fact remains that the decision whether to insure deposits at an institution is not a free-market, consensual transaction; FDIC must exercise its authority in strict accordance with the statutory and regultaory provisions cited in the text.

[17] The FDIC is authorized to borrow up to $30 billion from the United States Treasury "to be used by the [FDIC] solely in carrying out its functions with respect to [deposit] insurance." 12 U.S.C. 1824(a) (Supp. IV 1992). Moreover, the full faith and credit of the United States stands behind borrowing by the FDIC that meets certain statutory conditions. 12 U.S.C. 1825(d) (Supp. IV 1992).

[18] Various capital requirements for thrifts are set forth at 12 U.S.C. 1464(t) (Supp. IV 1992) and regulations promulgated in accordance iwth that statute. See also 12 U.S.C. 1831*o*(c)(3)(B) (Supp. IV 1992) (authority for federal banking agencies to set capital requirements); 12 C.F.R. 325.3 (FDIC capital requirements for insured banks).

the prime beneficiaries of the vast federal financial investment in the deposit insurance program are the insured financial institutions themselves and those—like petitioner—whose business is based in part on fees collected from them.

All of these facts put the FDIC in a quite different position from that of ordinary commercial creditors. They suggest that an imputation/estoppel defense that might be applicable to an ordinary commercial creditor ought not apply to the FDIC. Indeed, that is the lesson of *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447 (1942), which held that a side agreement that might, in ordinary circumstances, provide a perfectly proper defense to a bank's effort to collect on a note does not provide a defense when the FDIC attempts to collect on the same note after the bank has gone into receivership. See also *Deitrick* v. *Greaney*, 309 U.S. 190, 197-199 (1940) (holding that equitable estoppel defense based on fraud of bank stockholder is not applicable to the FDIC as receiver). Since the FDIC litigates virtually all of its significant cases in federal court, the States have not had the opportunity to take these situations into account in fashioning their imputation rules.

Whether an imputation defense in cases of this sort should apply thus depends on the effect of two circumstances—insolvency and the special role of the FDIC—that state courts rarely have the opportunity to address. Requiring federal courts to attempt to divine the hypothetical answers to questions that state tribunals rarely or never have the change to address would be unwise.[19] In such circumstances, there is a substantial need for a uniform federal rule of law.

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[19] The decisions demonstrate how tenuous the distinction between state and federal law is in this area. Indeed, the key decisions—as in this case—do not rely heavily on state sources, even when they are faithfully attempting to apply state law. See, *e.g.*, *Cenco*, 686 F.2d at 454 ("On this question, the Illinois cases on auditors' liability provide no guidance."); ***Investors Funding***, 523 F. Supp. at 540-541 (citing state sources for "controlling legal

3. Application of a rule of law giving the negligent professional tortfeasor a defense against the FDIC as receiver would also be inappropriate because this Court has long recognized that the rights of the FDIC as receiver for insolvent financial institutions implicate an area of "uniquely federal interests," *Boyle* v. *United Technologies Corp.*, 487 U.S. 500, 504 (1988) (citing *D'Oench, Duhme & Co.*, 315 U.S. at 457-458), where application of state law would frustrate the specific objectives of an important federal program. Applying state law rules that might not take into account the FDIC's special role in the nation's financial system could have that effect in circumstances like those in this case. If that occurred, there would be a risk of seriously injuring the federal deposit insurance system by depleting the deposit insurance fund and thus imposing the costs of professional malpractice on the nation's taxpayers, rather than on the negligent wrongdoer.

In addition, applying an imputation defense to insulate a law firm or other professional from liability for its own negligence would disserve the federal program by creating an incentive *against* diligent service to those thrift institutions that need it the most. Under petitioner's theory, a law or accounting firm working for a financially sound thrift whose insiders are not committing frauds would be fully liable for any malpractice it might commit. But if the financial institution's insiders were defrauding the institution, the attorney's or accountant's malpractice would be legally excused, even if—as here—that malpractice undoubtedly caused injury to the institution, its depositors and creditors, and the FDIC. On the other hand, if an attorney or accountant were to confront officers or directors with suspicions of wrongdoing or were otherwise to perform its duties to the institution aggressively,

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principles"—the adverse interest test—but not for application of those principles to tort suit by insolvent corporation); *Seidman & Seidman* v. *Gee*, 625 So. 2d at 2-3 (applying Florida law, but relying almost exclusively on *Cenco*).

it would risk being replaced by another firm. Indeed, that appears to have occurred in this case, when ADSB replaced Touche Ross with Arthur Young, and—more strikingly—when ADSB replaced Rogers & Wells with petitioner as counsel for its syndications.

To be sure, even under petitioner's theory, an intentional failure by a law or accounting firm to perform up to standards in an insolvency situation caused or aggravated by fraud might make the firm liable for complicity in the fraud, but such intentional malfeasance is extremely difficult to prove. The result would be that an attorney or accountant would have a perverse incentive to perform poorly at precisely the point where the institution itself, its creditors, and the FDIC have the greatest need for careful work. If professionals can contribute through their negligence to the insolvency of the institutions they serve, and then avoid liability on the ground that wrongdoing insiders were corrupt, the federal goals of promoting the stability and integrity of financial institutions will be frustrated. As the nation has seen in the case of the thrift industry, that can lead to catastrophic results. See *Lincoln Sav. & Loan Ass'n* v. *Wall*, 743 F. Supp. 901, 920-921 (D.D.C. 1990).

4. Finally, contrary to petitioner's contentions (Pet. Br. 46-48), application of a federal rule that refuses to apply the imputation defense in the circumstances of this case will have no effect at all on reasonable commercial or professional expectations. As we have shown above, the authority in support of petitioner's claim that California—or other States—would apply an imputation defense in the circumstances of this case is extremely weak; on the contrary, the leading cases in the area support the court of appeals' result. There is no reason to believe that any responsible law firm would enter into a representation agreement—or that any insurance company would provide it with malpractice insurance—on the premise that, should malpractice occur, liability would be in accordance

with state court decisions regarding holders in due course of commercial paper.

Moreover, even in the unlikely event that the law of California and other jurisdictions might shield petitioner from liability for its negligence based on the fraud of ADSB's insiders, that would still provide no support for petitioner's reliance argument. Any law firm attempting to determine how to represent a client properly must assume that it will be held fully liable for negligent performance of its state-law duty not to commit malpractice. Although it is possible that the firm might commit malpractice but be saved because an insider's fraud has shielded it from liability, no responsible law firm or malpractice insuror could reasonably premise their conduct or commercial arrangements on the possibility of such a windfall defense.

Finally, even if it were to be assumed that state law would provide a defense in the circumstances of this case, and even if a law firm might in some way reasonably rely on that defense in planning its representation of its clients, petitioner's argument would still have little force. It certainly would come as no surprise to professionals in the field that federally insured financial institutions can become insolvent; that a federal agency usually is appointed receiver for such an insolvent institution; and that the presence of the FDIC as receiver may alter the rights and obligations that might otherwise apply under state law. See, *e.g.*, *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447 (1942); *Langley* v. *FDIC*, 484 U.S. 86 (1987). A law firm that nonetheless entered into a representation agreement with a federally insured financial institution on the premise that federal law could not possibly apply if the institution went into receivership would be basing its conduct on wishful thinking, not reasonable commercial or professional judgment.

II. NOTHING IN FIRREA SUGGESTS THAT CONGRESS INTENDED STATE LAW TO GOVERN APPLICATION OF THE IMPUTATION DEFENSE IN THIS CASE

In its brief on the merits before this Court, petitioner principally argues (Pet. Br. 17-31) that Congress "left no room for judicial creation of a federal rule of decision to govern the tort claims of the FDIC as the receiver of a failed thrift" when it enacted FIRREA. Pet. Br. 31. Petitioner has not previously advanced that argument in any filing in this litigation.[20] Petitioner's argument is, in all events, supported neither by the case law on which it relies nor by anything in the text or history of FIRREA.[21]

1. Petitioner does not and cannot claim that Congress intended in FIRREA to "cover the field" of—and entirely eliminate—professional malpractice suits by the FDIC as receiver for insolvent financial institutions. According to petitioner, even after FIRREA such suits may be brought, so long as they are litigated entirely under state law. See Pet. Br. 24-26, 31. Thus, in order for petitioner to prevail on its new-found argument, it must demonstrate that, by enacting FIRREA, Congress intended completely to displace any federal common law governing malpractice actions by the FDIC, but nevertheless to leave state law governing such suits entirely intact. Petitioner's burden on that point is substantial; as this Court recently recognized in speaking of a federal common law doctrine

[20] Petitioner charges (Pet. Br. 19) that the court of appeals "ignored" FIRREA. In fact, the Court expressly referred to provisions of FIRREA other than those now cited by petitioner. See Pet. App. 2a n.2. Had petitioner brought the provisions of FIRREA it believes significant to the attention of the court of appeals, the court would have been more likely to address them.

[21] FIRREA was enacted on August 9, 1989. This suit, which was commenced on May 12, 1989, arose from events that occurred in 1985. We assume for purposes of this argument (as, apparently, does petitioner) that FIRREA would have taken effect in time to be relevant to this case.

alleged to have been superseded by statute, "[i]n order to abrogate a common law principle, the statute must 'speak directly' to the question addressed by the common law." *United States* v. *Texas,* 113 S. Ct. 1631, 1634 (1993).

2. Of the three primary cases cited by petitioner (see Pet. Br. 17-19) in support of its novel argument, two did not reach the conclusion that a federal statute displaced federal common law, while leaving state law fully intact. Those two cases are therefore entirely inapposite.

a. In *Northwest Airlines, Inc.* v. *Transport Workers Union,* 451 U.S. 77, 95 n.34 (1981), this Court refused to imply a federal common law right of contribution in favor of a defendant who violated the Equal Pay Act and Title VII and against a union that bore partial responsibility for those statutory violations. The Court relied on the facts that "[t]he liability of [the defendant] for discriminating against its female cabin attendants is entirely a creature of federal statute," and that those federal statutes constituted "a comprehensive legislative scheme including an integrated system of procedures for enforcement." 451 U.S. at 97. Neither of those factors is present here. More important, however, the Court concluded that it would not upset the legislative balance by adding a new common law remedy of contribution to the "comprehensive" federal statutory scheme creating the cause of action; it did not even suggest that state law would be available to supply any such right. To the contrary, the Court expressly held that cases recognizing "a right to contribution under state law in cases in which state law supplied the appropriate rule of decision" were "inapposite." *Id.* at 97 n.38.

b. In *Langley* v. *FDIC,* 484 U.S. 86 (1987), the Court held that, under 12 U.S.C. 1823(e), borrowers on a note could not rely on an unwritten side agreement to defend against an action on the note by the FDIC. Petitioner asserts (Pet. Br. 18-19) that, because the side agreement would have violated the common law doctrine of *D'Oench, Duhme,* and because the Court relied on the statute rather than that common law doctrine to decide the case, *Langley* stands for the proposition that federal common law no longer governs the assertion of equitable defenses against the FDIC.

In *Langley,* this Court certainly decided to apply the statute, rather than the common law *D'Oench, Duhme* doctrine, to bar the defense asserted by the borrower. There is nothing in the decision, however, to suggest that the Court *sub silentio* held that the statute provided the *sole* standard to govern the validity of side agreements asserted against the FDIC. To the contrary, the Court relied on *D'Oench, Duhme* to interpret the statute. See 484 U.S. at 92-93. And the federal courts of appeals, both before and after *Langley,* have uniformly concluded that a side agreement must comport *both* with Section 1823(e) *and* with the common law *D'Oench, Duhme* doctrine in order to be valid as against the FDIC.[22] Cf. *United*

[22] See, *e.g., FDIC* v. *Wright,* 942 F.2d 1089 (7th Cir. 1991) (FIRREA did not displace D'Oench doctrine), cert. denied, 112 S. Ct. 1937 (1992); *FSLIC* v. *Griffin,* 935 F.2d 691, 698 (5th Cir. 1991) (Section 1823(e) does not preclude application of *D'Oench, Duhme*), cert. denied, 112 S. Ct. 1163 (1992); *FDIC* v. *Kasal,* 913 F.2d 487, 491 (8th Cir. 1990) (applying both Section 1823(e) and *D'Oench, Duhme*), cert. denied, 498 U.S. 1119 (1991); *Hall* v. *FDIC,* 920 F.2d 334, 339 (6th Cir. 1990) (rejecting contention that "the common law doctrine of *D'Oench* is limited by the terms of § 1823(e)"), cert. denied, 111 S. Ct. 2852 (1991); *FSLIC* v. *Murray,* 853 F.2d 1251, 1254 (5th Cir. 1988) (holding that *D'Oench* doctrine applies to FSLIC); *Taylor Trust* v. *Security Trust Fed. Sav. & Loan Ass'n,* 844 F.2d 337, 342 (6th Cir. 1988) (same); *FDIC* v. *McClanahan,* 795 F.2d 512, 514 n.1 (5th Cir. 1986) (noting that the "discussion of [Section 1823(e)] in the legislative history does not mention *D'Oench, Duhme* * * * and there is no reason to suppose that Congress intended to forbid the rule of estoppel from being applied"); *FDIC v. de Jesus Velez,* 678 F.2d 371, 375-376 (1st Cir. 1982) (applying both Section 1823(e) and *D'Oench, Duhme*); cf. *FDIC* v. *Wood,* 758 F.2d 156, 159 (5th Cir.) (holding

States v. *Texas,* 113 S. Ct. 1631. Moreover, contrary to petitioner's suggestion, the Court in *Langley* did *not* "ma[k]e plain that it would not protect asserted federal interests that were not protected by the language of the statute." Pet. Br. 18. The Court simply "made plain" that the statute did not invalidate certain defenses not asserted in *Langley*—such as "fraud in the factum." 484 U.S. at 93-94. In doing so, the Court had no occasion to consider whether such defenses would have been invalidated by an application of the *D'Oench, Duhme* doctrine and whether, if so, they would nonetheless be valid as against the FDIC.

Finally, even if petitioner's improbable argument were accepted that the Court determined *sub silentio* in *Langley* that Section 1823(e) supplants, rather than supplements, the *D'Oench, Duhme* doctrine, it would do no good for petitioner here. Although they cover a variety of other situations, both Section 1823(e) and *D'Oench, Duhme* address the question of whether a secret side agreement may constitute a defense to an action on a note by FDIC as receiver for an insured financial institution. None of the provisions of FIRREA cited by petitioner similarly specifically address the availability of an imputation defense in a malpractice action brought by the FDIC. It is a remarkable feat of statutory construction to conclude that FIRREA nevertheless codified the law pertaining to the availability of that defense.

3. Petitioner also cites *City of Milwaukee* v. *Illinois,* 451 U.S. 304, 314 (1981). In that case, the Court held that Congress's intent in enacting the Federal Water Pollution Control Act Amendments of 1972 (the 1972 Amendments), Pub. L. No. 92-500, 86 Stat. 816, "was clearly to establish an all-encompassing program of water pollution regulation," 451 U.S. at 318, which left no

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federal common law holder in due course doctrine applicable, notwithstanding Section 1823(e)), cert. denied, 474 U.S. 944 (1985).

further "room for courts to attempt to improve on that program with federal common law," *id.* at 319. The Court also suggested that state common law may still continue to operate to a limited extent in support of the purposes of the 1972 Amendments in areas not otherwise preempted. 451 U.S. at 312-313, 323-324, 327-328. But the conclusion in that case that Congress intended to displace federal common law and leave some state law intact in enacting the 1972 Amendments provides no support for a similar conclusion with respect to FIRREA.

As the Court in *City of Milwaukee* painstakingly describes, Congress intended the 1972 Amendments to create "a comprehensive program for controlling and abating water pollution." 451 U.S. at 319.[23] The 1972 Amendments established "a new system of regulation" that made it illegal for anyone to discharge pollution without a permit. *Id.* at 310-311. The permits were to be "issued either by the [Environmental Protection Agency] or a qualifying state agency." *Id.* at 311. The 1972 Amendments carefully specified the circumstances under which permits could be issued and the requirements that had to be included in permits, but also expressly reserved to the States authority to set more stringent limitations. See *id.* at 327-328. And the 1972 Amendments established a comprehensive enforcement system, allocating specific roles to the EPA, state agencies, and suits brought by public agencies and private citizens. See generally *Gwaltney of Smithfield, Ltd.* v. *Chesapeake Bay Foundation, Inc.*, 484 U.S. 49 (1987).

None of the features that led to the Court's decision in *City of Milwaukee* are present in this case. The specific problem that Illinois sought to remedy in that

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[23] The Court noted that "[n]o Congressman's remarks on the legislation were complete without reference to the 'comprehensive' nature of the [1972 Amendments]." 451 U.S. at 318. It found that the 1972 Amendments were designed "to establish a *comprehensive* long-range policy for the elimination of water pollution." *Ibid.*

case—the discharge of pollutants into navigable waters—had been specifically and exhaustively addressed by Congress through the creation of a highly articulated administrative process. That process plainly governed the legitimacy of the discharges at issue in *City of Milwaukee*, and the City had in fact obtained discharge emission permits in accordance with it. 451 U.S. at 323-324. Permitting the development of a body of federal common law to govern the City's discharges would have simply amounted to extra-statutory judicial review of the federal and state administrative processes. *Id.* at 324. Such judicial review would have conflicted with the specific standards governing discharges of pollutants that Congress and the agencies to which it delegated power had developed. *Id.* at 324-325. It also would have conflicted with orderly judicial review of the agencies' actions through procedures established in accordance with federal and state law. Insofar as state common law continued to apply to discharges of pollutants, it was because Congress expressly provided that state law—including state common law—could impose *more stringent standards* than those provided for by the 1972 Amendments. See *id.* at 327 (discussing Section 510 of the statute, 33 U.S.C. 1370). Finally, the Court relied in part on the fact that federal common law would be particularly inappropriate because of the difficulty of applying the "ad hoc" approach of federal common law in an area of such great scientific and technical complexity. 451 U.S. at 325.

4. Petitioner essentially proposes three distinct ways in which FIRREA supposedly has covered the field at issue in this case so as to preclude the normal application of federal common law.

a. First, petitioner asserts (Pet. Br. 19-20) that a congressional intent to preempt federal common law

can be derived from the provision of FIRREA providing that the FDIC as receiver "succeed[s] to * * * all rights, titles, powers, and privileges of the insured depository institution." 12 U.S.C. 1821(d)(2)(A)(i) (Supp. IV 1922).[24] That provision is plainly intended to grant the FDIC certain rights as receiver; it does not purport, nor can it sensibly be read, to limit the FDIC's rights in any way. Indeed, later in the same section, Congress made quite clear that Section 1821(d)(2)(A) does not limit the FDIC's authority in this way or suggest that the FDIC has *only* the specific rights specified in that section by providing that that FDIC "may, as conservator or receiver * * * exercise all powers and authorities specifically granted to conservators or receivers * * * under this chapter *and such incidental powers as shall be* necessary to carry out such powers." 12 U.S.C. 1821(d)(2)(J) (Supp. IV 1992) (emphasis added). See also 12 U.S.C. 1821(d)(1) (Supp. IV 1992) (providing that FDIC "may prescribe such regulations as [it] determines to be appropriate regarding the conduct of conservatorships or receiverships"). As the *D'Oench, Duhme* doctrine establishes, receivers in some circumstances are not subject to defenses that might be available against the corporation to whose assets they succeed.[25] Congress did not intend to overrule that principle when it enacted FIRREA.

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[24] In one of its two alternative holdings, the Ninth Circuit held in this case that Sahni's and Day's wrongdoing could not be imputed to ADSB. See Pet. App. 10a-13a. That holding is sufficient to resolve this case, even if Section 1821(d)(2)(A)(i) could be read, as petitioner argues, strictly to limit the FDIC's rights as receiver to the precise rights that could have been exercised by the management of the insured financial institution itself.

[25] Cf. *Texas & Pacific Ry.* v. *Pottorff*, 291 U.S. 245, 260-261 (1934) ("even if the bank would have been estopped from asserting lack of power, its receiver would be free to challenge the validity of the pledge").

b. Second, petitioner argues (Pet. Br. 21-22) that FIRREA covers the field of defenses applicable to the FDIC as receiver. In that connection, petitioner cites a variety of provisions granting the FDIC certain powers and specifying certain rules that are to be applicable to suits brought by the FDIC.

For example, one of the provisions cited, 12 U.S.C 1821(e) (Supp. IV 1992), grants the FDIC as receiver the authority to repudiate contracts, 12 U.S.C. 1821(e)(1)-(2) (Supp. IV 1992), provides detailed instructions concerning the exercise of and consequences of such a repudiation, 12 U.S.C. 1821(e)(4)-(11) (Supp. IV 1992), and provides for claims and damages when that authority is exercised, 12 U.S.C. 1821(e)(3) (Supp. IV 1992). Section 1821(e), however, clearly does not mean generally to govern the assertion of equitable defenses against FDIC; its specific purpose is to codify what had previously been a federal common law doctrine concerning only the FDIC's power as receiver to repudiate contracts.[26]

Another provision on which petitioner relies provides for a statute of limitations applicable to actions brought by FDIC as receiver. See 12 U.S.C. 1821(d)(14) (Supp. IV 1992). That provision was plainly intended to supplant shorter state statutes of limitations, not fed-

[26] Although the authority of FSLIC as receiver to repudiate contracts was codified at 12 C.F.R. 569a.6(c)(3) (1982) and 12 C.F.R. 549.3(a) (1982), the FDIC had no parallel regulation. The courts had, however, recognized that, as receiver, FDIC necessarily had that authority. See, *e.g.*, *FDIC* v. *Grella*, 553 F.2d 258, 262-263 (2d Cir. 1977); *Argonaut Sav. & Loan Ass'n* v. *FDIC*, 392 F.2d 195, 197 (9th Cir.), cert. denied, 393 U.S. 839 (1968). Since FIRREA, the FDIC's powers to repudiate contracts are codified at 12 U.S.C. 1821(e) (Supp. IV 1992), and the Resolution Trust Corporation's similar powers are codified at 12 U.S.C. 1441a(b)(4)(A) (Supp. IV 1992). As the Committee Report on those provisions stated, they were intended to "incorporate[] rights and principles established at common law or in bankruptcy." S. Rep. No. 19, 101st Cong., 1st Sess. 314 (1989).

eral common law generally. See, *e.g.*, *FDIC* v. *New Hampshire Ins. Co.*, 953 F.2d 478, 486-488 (9th Cir. 1992); *FDIC* v. *McSweeney*, 976 F.2d 532, 534-536 (9th Cir. 1992), cert. denied, 113 S. Ct. 2440 (1993). In any event, Section 1821(d)(14) certainly does not govern the equitable defenses that may be asserted against the FDIC. Nor is there any basis for the proposition that its enactment reflected a general intent to limit the scope of federal common law, while leaving state common law intact, as petitioner argues.

One provision cited by petitioner, 12 U.S.C. 1823(e) (Supp. IV 1992), does directly govern an equitable defense that may be asserted against the FDIC. That provision is the one at issue in *Langley*, which renders certain unwritten and unrecorded side agreements unenforceable against the FDIC in an action on a note.[27] FIRREA slightly altered the wording of that provision, which was originally enacted in 1950. See Federal Deposit Insurance Act of 1950, ch. 967, § 2[13] [e], 64 Stat. 889. As explained above, see note 22, *supra*, although the provision does overlap the *D'Oench Duhme* doctrine substantially, the courts of appeals in the years since 1950 have recognized that it supplements, rather than supplants, the common law doctrine. As such, it could not possibly be read to have supplanted the entire field of federal common law regarding the defenses that may be asserted in suits brought by the FDIC as receiver.

c. Finally, petitioner cites two provisions of FIRREA that address malfeasance by financial institution insiders and professionals employed by such institutions. One of them, 12 U.S.C. 1821(k) (Supp. IV 1992), provides that the FDIC may bring suit against directors or officers of insured depository institutions for damages caused by

[27] Another provision cited by petitioner (Pet. Br. 22) 12 U.S.C. 1821(d)(9) (Supp. IV 1992), applies the rule of Section 1823(e) to claims *against* FDIC.

their "gross negligence." Outside attorneys and accountants are not governed by that provision, and it would be odd to read it to have any effect on malpractice actions against them. In any event, however, Congress made quite clear the extent to which it intended Section 1821 (k) to preempt other sources of law by providing that "[n]othing in this [Section] shall impair or affect any right of the [FDIC] under other applicable law." 12 U.S.C. 1821(k) (Supp. IV 1992). There is no reason not to take that language literally.[28]

FIRREA also modified the pre-existing authority of FDIC as regulator to impose administrative penalties on individuals affiliated with insured financial institutions. Prior to the enactment of FIRREA, both the FDIC and FSLIC could impose administrative sanctions for violation of the agency's orders against directors and officers of regulated institutions, as well as others who "participat[ed] in the conduct of the affairs" of such institutions. 12 U.S.C. 1818(i)(2)(i) (1988).[29] Cf. *Reves*

[28] The purpose of Section 1821(k) was to preempt state laws that purport to insulate officers or directors of financial institutions from liability. See *FDIC* v. *McSweeney*, 976 F.2d at 539-540; *FDIC* v. *Canfield*, 967 F.2d 443, 448 n.6 (10th Cir.) (en banc), cert. dismissed, 113 S. Ct. 516 (1992). As the Senate Report explained, Section 1821(k) "does not prevent the FDIC from pursuing claims under State law *or under other applicable Federal law*, if such law permits the officers or directors of a financial institution to be sued * * * for violating a lower standard of care, such as simple negligence." S. Rep. No. 19, *supra*, at 318 (emphasis added).

[29] 12 U.S.C. 1818(i)(2)(i) (1988) provided that "[a]ny insured bank" or "any officer, director, employee, agent, or other person participating in the conduct of the affairs of such a bank who violates" a final order of the "appropriate Federal banking agency" may be fined up to $1,000 per day. That provision thus applied to attorneys only insofar as they "participat[ed] in the conduct of the affairs" of the institution. The term "appropriate Federal banking agency" was defined to include, *inter alia*, the FDIC and

v. *Ernst & Young*, 113 S. Ct. 1163 (1993). FIRREA augmented that procedure by dramatically increasing the maximum penalty[30] and by enlarging the types of conduct that would subject a party to an administrative penalty to include, in specified circumstances, "recklessly engag[ing] in an unsafe or unsound practice," 12 U.S.C. 1818(i)(2)(B)(i)(II) (Supp. IV 1992), "breach[ing] any fiduciary duty," 12 U.S.C. 1818(i)(2)(B)(i)(III) Supp. IV 1992), and "knowingly or recklessly caus[ing] a substantial loss" to the institution, 12 U.S.C. 1818 (i)(2)(C)(ii) (Supp IV 1992). FIRREA also widened the category of attorneys and accountants who could be subject to the administrative penalty; that group was enlarged to include any attorney or accountant "who knowingly or recklessly" committed one of the administrative infractions mentioned above. 12 U.S.C. 1813(u) (4) (Supp. IV 1992).[31]

FIRREA's modification of the FDIC administrative penalty provision in no way suggests that Congress intended to preempt all federal common law—but not state common law—principles that might govern attorney malpractice suits, as petitioner suggests. On the contrary, Congress's strengthening of the administrative penalty provision has nothing to do with *limiting* the scope or nature of negligence actions that may be brought against professionals employed by insured institutions, or with the rules of law that apply to such actions.

the Federal Home Loan Bank Board, which regulated thrift institutions. 12 U.S.C. 1813(q) (1988).

[30] Prior to FIRREA, the maximum penalty was $1,000 per day. 12 U.S.C. 1818(i)(2)(i) (1988). FIRREA established a graduated schedule with penalties ranging from a maximum of $5,000 per day to a maximum of $1,000,000 per day, depending on the nature of the violation. See 12 U.S.C. 1818(i)(2) (Supp. IV 1992).

[31] Section 1813(u) defines the term "institution-affiliated party." In turn, 12 U.S.C. 1818(i)(2) (Supp. IV 1992) grants the FDIC authority to impose penalties on any "institution-affiliated party."

An administrative penalty and a negligence action for damages are not plausible substitutes for one another, such that Congress could be understood to have eliminated the latter when it strengthened the former. Administrative penalty proceedings serve deterrent purposes, while the primary function of a tort suit is to compensate the victim of the tort. Administrative penalty proceedings may be instituted against those associated with institutions regardless of whether the institutions are solvent or in receivership, while negligence actions brought by the FDIC as receiver are by definition brought only against individuals who have harmed an insolvent institution. In addition, administrative penalties are to be assessed in proportion to the seriousness of the misconduct, while in negligence actions, damages are measure by the loss suffered by the victim. Finally, administrative penalties must by statute be deposited in the federal treasury, 12 U.S.C. 1818(i)(2)(J) (Supp. IV 1992), while the proceeds of a malpractice action go to the insurance fund or the receivership estate to repay the fund or the estate for the harm done by the negligence. In light of these striking differences between the two remedies it would be illogical to conclude that Congress implicitly intended to restrict suits for professional malpractice by strengthening the administrative penalties available against attorneys and accountants for their misconduct.

* * * * *

At bottom, petitioner's argument is that, because Congress enacted legislation governing the legal relations of the FDIC in certain specific areas that were formerly governed by federal common law or state law, Congress's silence on other matters should somehow be read to have entirely supplanted the field of federal common law governing the FDIC, while somehow leaving state common law intact. That is a highly unlikely conclusion, especially because two of this Court's earliest and most prominent federal common law decisions after *Erie R.R.* v.

Tompkins, 304 U.S. 64 (1938), concerned the rights and responsibilities of the FDIC as receiver. See *Deitrick* v. *Greaney*, 309 U.S. 190 (1940); *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447 (1942). FIRREA itself was enacted to "*strengthen* the enforcement powers of Federal regulators of depository institutions," § 101(9), 103 Stat. 187 (codified at 12 U.S.C. 1811 note (Supp. IV 1992) (emphasis added)) not to limit them. The federal common law rule that we advocate in this case is fully consistent with the leading cases and with the prevalent state common law rules governing the subject. It is the only rule that adequately takes into account the unique federal interests that come into play when the FDIC becomes receiver of an insured depository institution. The Ninth Circuit's decision should therefore be affirmed.

CONCLUSION

The decision of the Ninth Circuit should be affirmed.

Respectfully submitted.

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FEBRUARY 1994

APPENDIX

12 U.S.C. 1813

* * * * *

(q) Appropriate Federal banking agency

The term "appropriate Federal banking agency" means—

(1) the Comptroller of the Currency, in the case of any national banking association, any District bank, or any Federal branch or agency of a foreign bank;

(2) the Board of Governors of the Federal Reserve System, in the case of—

(A) any State member insured bank (except a District bank),

(B) any branch or agency of a foreign bank with respect to any provision of the Federal Reserve Act [12 U.S.C.A. § 221 et seq.] which is made applicable under the International Banking Act of 1978 [12 U.S.C.A. § 3101 et seq.],

(C) any foreign bank which does not operate an insured branch,

(D) any agency or commercial lending company other than a Federal agency,

(E) supervisory or regulatory proceedings arising from the authority given to the Board of Governors under section 7(c)(1) of the International Banking Act of 1978 [12 U.S.C.A. § 3105(b)(1)], including such proceedings under the Depository Institutions Supervisory Act, and

(F) any bank holding company and any subsidiary of a bank holding company (other than a bank);

(3) the Federal Deposit Insurance Corporation in the case of a State nonmember insured bank (except a District bank), or a foreign bank having an insured branch; and

(4) the Director of the Office of Thrift Supervision in the case of any savings association or any savings association or any savings and loan holding company.

Under the rule set forth in this subsection, more than one agency may be an appropriate Federal banking agency with respect to any given institution.

* * * * *

(u) Institution Affiliated Party.—The term "institution-affiliated party" means—

(1) any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution;

(2) any other person who has filed or is required to file a change-in-control notice with the appropriate Federal banking agency under section 1817(j) of this title;

(3) any shareholder (other than a bank holding company) consultant, joint venture partner, and any other person as determined by the appropriate Federal banking agency (by regulation or case-by-case) who participates in the conduct of the affairs of an insured depository institution; and

(4) any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in—

(A) any violation of any law or regulation;

(B) any breach of fiduciary duty; or

(C) any unsafe or unsound practice,

which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution.

* * * * *

12 U.S.C. 1818

* * * * *

(i) Jurisdiction and enforcement; penalty

(1) The appropriate Federal banking agency may in its discretion apply to the United States district court, or the United States court of any territory, within the jurisdiction of which the home office of the depository institution is located, for the enforcement of any effective and outstanding notice or order issued under this section or under section 1831*o* or 1831p-1 of this title, and such courts shall have jurisdiction and power to order and require compliance herewith; but except as otherwise provided in this section or under section 1831*o* or 1831p-1 of this title no court shall have jurisdiction to affect by injunction or otherwise the issuance or enforcement of any notice or order under any such section, or to review, modify, suspend, terminate, or set aside any such notice or order.

(2) Civil money penalty.—

(A) First tier.—Any insured depository institution which, and any institution-affiliated party who—

(i) violates any law or regulation;

(ii) violates any final order or temporary order issued pursuant to subsection (b), (c), (e), (g), or (s) of this section or any final order under section 1831*o* or 1831p-1 of this title;

(iii) violates any condition imposed in writing by the appropriate Federal banking agency

in connection with the grant of any application or other request by such depository instituiton; or

(iv) violates any written agreement between such depository institution and such agency,

shall forfeit and pay a civil penalty of not more than $5,000 for each day during which such violation continues.

(B) SECOND TIER.—Notwithstanding subparagraph (A), any insured depository institution which, and any institution-affiliated party who—

(i)(I) commits any violation described in any clause of subparagraph (A);

(II) recklessly engages in an unsafe or unsound practice in conducting the affairs of such insured depository institution; or

(III) breaches any fiduciary duty;

(ii) which violation, practice, or breach—

(I) is part of a pattern of misconduct;

(II) causes or is likely to cause more than a minimal loss to such depository institution; or

(III) results in pecuniary gain or other benefit to such party,

shall forfeit and pay a civil penalty of not more than $25,000 for each day during which such violation, practice, or breach continues.

(C) THIRD TIER.—Notwithstanding subpragraphs (A) and (B), any insured depository institution which, and any institution-affiliated party who—

(i) knowingly—

(I) commits any violation described in any clause of subparagraph (A);

(II) engages in any unsafe or unsound practice in conducting the affairs of such depository institution; or

(III) breaches any fiduciary duty; and

(ii) knowingly or recklessly causes a substantial loss to such depository institution or a substantial pecuniary gain or other benefit to such party by reason of such violation, practice, or breach,

shall forfeit and pay a civil penalty in an amount not to exceed the applicable maximum amount determined under subparagraph (D) for each day during which such violation, practice, or breach continues.

(D) MAXIMUM AMOUNTS OF PENALTIES FOR ANY VIOLATION DESCRIBED IN SUBPARAGRAPH (c).—The maximum daily amount of any civil penalty which may be assessed pursuant to subparagraph (C) for any violation, practice, or breach described in such subparagraph is—

(i) in the case of any person other than an insured depository institution, an amount to not exceed $1,000,000; and

(ii) in the case of any insured depository institution, an amount not to exceed the lesser of—

(I) $1,000,000; or

(II) 1 percent of the total assets of such institution.

(E) ASSESSMENT.—

(i) WRITTEN NOTICE.—Any penalty imposed under subparagraph (A), (B), or (C) may be assessed and collected by the appropriate Federal banking agency by written notice.

(ii) FINALITY OF ASSESSMENT.—If, with respect to any assessment under clause (i), a hearing is not requested pursuant to subparagraph (H) within the period of time allowed under such subparagraph, the assessment shall constitute a final and unappealable order.

(F) AUTHORITY TO MODIFY OR REMIT PENALTY.—Any appropriate Federal banking agency may compromise, modify, or remit any penalty which such agency may assess or had already assessed under subparagraph (A), (B), or (C).

(G) MITIGATING FACTORS.—In determining the amount of any penalty imposed under subparagraph (A), (B), or (C), the appropriate agency shall take into account the appropriateness of the penalty with respect to—

(i) the size of financial resources and good faith of the insured depository institution or other person charged;

(ii) the gravity of the violation;

(iii) the history of previous violations; and

(iv) such other matters as justice may require.

(H) HEARING.—The insured depository institution or other person against whom any penalty is assessed under this paragraph shall be afforded an agency hearing if such institution or person submits a request for such hearing within 20 days after the issuance of the notice of assessment.

(I) COLLECTION.—

(i) REFERRAL.—If any insured depository institution or other person fails to pay an assessment after any penalty assessed under this paragraph has become final, the agency that imposed

the penalty shall recover the amount assessed by action in the appropriate United States district court.

(ii) APPROPRIATENESS OF PENALTY NOT REVIEWABLE.—In any civil action under clause (i), the validity and appropriateness of the penalty shall not be subject to review.

(J) DISBURSEMENT.—All penalties collected under authority of this paragraph shall be deposited into the Treasury.

(K) REGULATIONS.—Each appropriate Federal banking agency shall prescribe regulations establishing such procedures as may be necessary to carry out this paragraph.

(3) NOTICE UNDER THIS SECTION AFTER SEPARATION FROM SERVICE.—The resignation, termination of employment or participation, or separation of a institution-affiliated party (including a separation caused by the closing of an insured depository institution shall not affect the jurisdiction and authority of the appropriate Federal banking agency to issue any notice and proceed under this section against any such party, if such notice is served before the end of the 6-year period beginning on the date such party ceased to be such a party with respect to such depository institution (whether such date occurs before, on, or after August 9, 1989).

(4) PREJUDGEMENT ATTACHMENT.—

(A) IN GENERAL.—In any action brought by an appropriate Federal banking agency (excluding the Corporation when acting in a manner described in section 1821(d)(18) of this title) pursuant to this section, or in actions brought in aid of, or to enforce an order in, any administrative or other civil action for money damages, restitution, or civil money penalties brought by such agency, the court may, upon

application of the agency, issue a restraining order that—

(i) prohibits any person subject to the proceeding from withdrawing, transferring, removing, dissipating, or disposing of any funds, assets or other property; and

(ii) appoints a temporary receiver to administer the restraining order.

(B) STANDARD.—A permanent or temporary injunction or restraining order shall be granted without bond upon a prima facie showing that money damages, restitution, or civil money penalties, as sought by such agency, is appropriate.

* * * * *

12 U.S.C. 1821

* * * * *

(d) Powers and duties of Corporation as conservator or receiver

(1) Rulemaking authority of Corporation

The Corporation may prescribe such regulations as the Corporation determines to be appropriate regarding the conduct of conservatorships or receiverships.

(2) General powers

(A) Successor to institution

The Corporation shall, as conservator or receiver, and by operation of law, succeed to—

(i) all rights, titles, powers, and privileges of the insured depository institution, and of any stockholder, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution; and

(ii) title to the books, records, and assets of any previous conservator or other legal custodian of such institution.

* * * * *

12 U.S.C. 1821(d)(2):

(J) Incidental powers

The Corporation may, as conservator or receiver—

(i) exercise all powers and authorities specifically granted to conservators or receivers, respectively, under this chapter and such incidental powers as shall be necessary to carry out such powers; and

(ii) take any action authorized by this chapter,

which the Corporation determines is in the best interests of the depository institution, its depositors, or the Corporation.

* * * * *

12 U.S.C. 1821(d):

(9) Agreement as basis of claim

(A) Requirements

Except as provided in subparagraph (B), any agreement which does not meet the requirements set forth in section 1823(e) of this title shall not form the basis of, or substantially compromise, a claim against the receiver or the Corporation.

(B) Exception to contemporaneous execution requirement

Notwithstanding section 1823(e)(2) of this title, any agreement relating to an extension of credit between a Federal home loan bank or Federal Reserve bank and any insured depository institution which was executed before the extension of credit by such bank to such institution shall be treated as having been executed contemporaneously with such extension of credit for purposes of subparagraph (A).

* * * * *

(14) Statute of limitations for actions brought by conservator or receiver

(A) In general

Notwithstanding any provision of any contract, the applicable statute of limitations with regard to any action brought by the Corporation as conservator or receiver shall be—

(i) in the case of any contract claim, the longer of—

(I) the 6-year period beginning on the date the claim accrues; or

(II) the period applicable under State law; and

(ii) in the case of any tort claim, the longer of—

(I) the 3 year period beginning on the date the claim accrues; or

(II) the period applicable under State law.

(B) Determination of the date on which a claim accrues

For purposes of subparagraph (A), the date on which the statute of limitation begins to run

on any claim described in such subparagraph shall be the later of—

(i) the date of the appointment of the Corporation as conservator or receiver; or

(ii) the date on which the cause of action accrues.

* * * * *

(e) Provisions relating to contracts entered into before appointment of conservator or receiver

(1) Authority to repudiate contracts

In addition to any other rights a conservator or receiver may have, the conservator or receiver for any insured depository institution may disaffirm or repudiate any contract or lease—

(A) to which such institution is a party;

(B) the performance of which the conservator or receiver, in the conservator's or receiver's discretion, determines to be burdensome; and

(C) the disaffirmance or repudiation of which the conservator or receiver determines, in the conservator's or receiver's discretion, will promote the orderly administration of the institution's affairs.

(2) Timing of repudiation

The conservator or receiver appointed for any insured depository institution in accordance with subsection (c) of this section shall determine whether or not to exercise the rights of repudiation under this subsection within a reasonable period following such appointment.

(3) Claims for damages for repudiation

(A) In general

Except as otherwise provided in subparagraph (C) and paragraphs (4), (5), and (6), the liability of the conservator or receiver for the disaffirmance or repudiation of any contract pursuant to paragraph (1) shall be—

(i) limited to actual direct compensatory damages; and

(ii) determined as of—

(I) the date of the appointment of the conservator or receiver; or

(II) in the case of any contract or agreement referred to in paragraph (8), the date of the disaffirmance or repudiation of such contract or agreement.

(B) No liability for other damages

For purposes of subparagraph (A), the term "actual direct compensatory damages" does not include—

(i) punitive or exemplary damages;

(ii) damages for lost profits or opportunity; or

(iii) damages for pain and suffering.

(C) Measure of damages for repudiation of financial contracts

In the case of any qualified financial contract or agreement to which paragraph (8) applies, compensatory damages shall be—

(i) deemed to include normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims; and

(ii) paid in accordance with this subsection and subsection (k) of this section

except as otherwise specifically provided in this section.

* * * * *

12 U.S.C. 1821:

(k) Liability of directors and officers

A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the Corporation, which action is prosecuted wholly or partially for the benefit of the Corporation—

(1) acting as conservator or receiver of such institution,

(2) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator, or

(3) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed in whole or in part by an insured depository institution or its affiliate in connection with assistance provided under section 1823 of this title,

for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

* * * * *

12 U.S.C. 1823

* * * * *

(e) Agreements against interests of Corporation

No agreement which tends to diminish or defeat the interest of the Corporation in any asset acquired by it

under this section or section 1821 of this title, either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the Corporation unless such agreement—

(1) is in writing,

(2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution,

(3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and

(4) has been, continuously, from the time of its execution, an official record of the depository institution.

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(16)

No. 93-489

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS,
a Law Partnership,
Petitioner,
v.

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS PARK II, and AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF OF PETITIONER

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March 4, 1994

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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REPLY BRIEF OF PETITIONER

I. FIRREA SPECIFIES THAT STATE LAW IS THE SOURCE OF THE FDIC'S RIGHTS.

A. The FDIC's response to petitioner's showing that FIRREA plainly precludes reliance upon a federal rule of decision in this case rests on a single premise: According to the FDIC, under *United States* v. *Texas*, 113 S. Ct. 1631 (1993), federal court power to create federal common law survives federal legislation unless the latter "speaks directly" to the specific legal issue. FDIC Br. 35-36, 38. According to the FDIC, *Texas* is not satisfied because 12 U.S.C. § 1821(d)(2)(A)(i) does not "speak directly" to a defense based on imputation.

As this Court made clear in *Texas*, however, the "speak directly" test applies only when there was an "existing," directly on-point federal common law rule prior to the statute. 113 S. Ct. at 1634. Specifically, in *Board of Comm'rs* v. *United States*, 308 U.S. 343 (1939), the Court had ruled that the federal government's right to prejudgment interest extended in particular cases to contractual "debts owed by state and local governments." *Texas*, 113 S. Ct. at 1634. The Debt Collection Act of 1982 enacted a "more onerous" rule for private debts, requiring mandatory prejudgment interest at a specified rate, but expressly exempted state and local government debts from the stricter statutory rule. *Id*. at 1635. The Court held that the more moderate, *preexisting* rule in *Board of Comm'rs* still applied to States. See *id*. at 1635-36.

Here, by contrast, prior to FIRREA there was no federal rule of decision, much less a directly on-point precedent of this Court, precluding the application of state law to professional malpractice claims brought by the FDIC. To the contrary, the most relevant precedents of this Court hold that tort claims against thrift receivers are governed by "state law." *Coit Independence Joint Venture* v. *FSLIC*, 489 U.S. 561, 585 (1989), and that the claims of federal receivers are generally subject to

defenses available against the institution, including defenses based on imputation, see Pet. Br. 20-21; *infra* at p. 12. Consistent with these precedents, prior to FIRREA lower courts had regularly held that state law governed tort claims brought by the FDIC and FSLIC, and the defenses thereto. See Pet. Br. 25 n.19.

Accordingly, the FDIC's reliance on *Texas* is misplaced because it is "difficult to argue," to say the least, that FIRREA "preserve[d] a federal common law remedy not yet recognized by this Court." *City of Milwaukee* v. *Illinois*, 451 U.S. 304, 327 n.19 (1981). The opinion of Justice Douglas for the Court in *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447 (1942), simply does not address whether, when the FDIC sues for malpractice, federal rules of decision should be created to supply the elements of FDIC's tort claims or the permissible defenses. The FDIC concedes that *D'Oench* is distinguishable and addresses only "the question whether a secret side agreement may constitute a defense to an action on a note by FDIC." FDIC Br. 38; see Pet. Br. 42 n.31, 46 n.33, 47 n.34. Both *D'Oench* and later decisions of this Court emphasize that *D'Oench* is limited to a defense by a borrower who knowingly participated in a secret agreement. See Pet. Br. 46 n.33.[1] Because the holding in *D'Oench* is unrelated to the issue here, the "speak directly" test does not apply.[2]

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[1] The FDIC miscites two preemption cases. In *Deitrick* v. *Greaney*, 309 U.S. 190 (1940), a borrower participated, "with full knowledge of the unlawful purpose," in the violation of a federal statute. *Id.* at 195, 198-201. In *Texas & Pacific Ry.* v. *Pottorff*, 291 U.S. 245 (1934), a depositor knowingly participated in a statutory violation. *Id.* at 252-54. Moreover, *Pottorff* involved a claim that could have been successfully brought by the bank (*id.* at 260), and dicta concerning a receiver's right to recover fraudulent conveyances, *id.* at 261, a right which is now codified at 12 U.S.C. § 1821(d)(17). Later decisions emphasize that *Greaney* and *Pottorff* are preemption cases. *See, e.g., Sola Elec. Co.* v. *Jefferson Co*,. 317 U.S. 173, 176 (1942); *Awotin* v. *Atlas Exchange Bank*, 295 U.S. 209, 213 (1935).

[2] Even if that test did apply, it would be satisfied here. To satisfy the test, Congress "need not 'affirmatively proscribe' the

What the FDIC seeks is not to preserve a federal tort rule that existed before FIRREA, but rather to create a new federal common law rule that goes well beyond both *D'Oench* and the statute.[3] In this situation, the Court must first determine whether a statute "addresses" the subject of FDIC's proposed federal common law rule of decision. *E.g.*, *Northwest Airlines, Inc.* v. *Transport Workers Union*, 451 U.S. 77, 95 n.34 (1981).[4] Section 1821(d)(2)(A)(i) of Title 12 plainly does.

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common law doctrine at issue." *Texas*, 113 S. Ct. 1634-35; *accord Astoria Fed. Sav. & Loan Ass'n* v. *Solimino*, 111 S. Ct. 2166, 2170 (1991) (there is no requirement of "clear statement" or "strict construction"); *City of Milwaukee* v. *Illinois*, 451 U.S. at 317 ("evidence of a clear and manifest purpose is not required"). Rather, the "speak directly" test is satisfied by the "natural meaning" of a statutory provision, *Isbrandtsen Co.* v. *Johnson*, 343 U.S. 779, 783 (1952), by a statutory listing of powers that omits the power claimed to exist under the common law, *id.* at 789, by a statutory provision that would be rendered "superfluous" by continued application of a common law rule, *Astoria*, 111 S. Ct. at 2172, or by "an implication" after application of the traditional tools of statutory interpretation, *id.* at 2171. Each of these is present here. *See infra* at pp. 4-7; *see also* Pet. Br. 19-31.

[3] Of course, in *Langley*, the FDIC argued strenuously that *D'Oench* was broader than 12 U.S.C. § 1823(e) and that this interpretation of *D'Oench* remained good law after enactment of the statute. *See* Brief For The FDIC, at 36-41 (No. 86-489). The Court squarely rejected this argument: "An agreement that meets [the requirements set forth in § 1823(e)] prevails even if the FDIC did not know of it . . . . It would be rewriting the statute to hold otherwise." *Langley* v. *FDIC*, 484 U.S. 86, 95 (1987).

[4] The FDIC attempts to distinguish *Northwest Airlines* and *City of Milwaukee* on the basis that the statutes there were comprehensive (*see* FDIC Br. 36, 38-40); but FIRREA is unquestionably comprehensive. *See* Pet. Br. 19, 21-28, 44-45; FDIC Br. 29-30, 42-46. Indeed, FIRREA's legislative history states that the statute's delineation of FDIC's rights as a receiver is "comprehensive." H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 415 (1989). More fundamentally, it is contrary to this Court's precedent to suggest that the Court should not follow a statute that addresses a subject because the statute is not sufficiently "comprehensive." *Mobil Oil Corp.* v. *Higginbotham*, 436 U.S. 618, 625 (1978) (rejecting argument that it was proper "to 'supplement' Congress' answer" on the

B. At the heart of the FDIC's proposed federal tort rule is the proposition that the FDIC enjoys greater rights against petitioner than did FDIC's predecessor, ADSB. See FDIC Br. 11, 27, 35. This contention is squarely, indeed directly, refuted by 12 U.S.C. § 1821(d)(2)(A)(i), which provides that in this case the FDIC as a receiver operates as a "Successor to [the] institution" and asserts the "rights . . . of the insured depository institution." See also *infra,* at pp. 12-13. This provision instructs a court to apply the same rule of decision to the FDIC's tort claims as applies to the claims if brought by the savings and loan. The FDIC does not dispute that state law governs tort claims brought by the savings and loan itself and the defenses thereto. See *Bank of Am. Nat'l Trust & Sav. Ass'n* v. *Parnell,* 352 U.S. 29, 33-34 (1956); Pet. Br. 23-26.[5] Because the statute answers the question of which law to apply, there is simply no need for further application of the *Kimbell Foods* test.

The FDIC makes only two arguments to the contrary. The first is the remarkable contention that the delineation by Congress of specific rights and remedies does not "in any way" limit judicial authority to create additional federal common law rights. FDIC Br. 41. This argument renders meaningless the statutory provision that specifies

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basis that "Congress has never enacted a *comprehensive* maritime code") (emphasis added).

[5] The FDIC also does not dispute that state law applies to the claims of the other three plaintiffs in this case—*i.e.*, ADSB's subsidiary, ADCFC, a California corporation, and the two partnerships in which ADCFC is general partner. As *amici* demonstrated, pursuant to *Finley* v. *United States,* 490 U.S. 545 (1989), the federal courts lack jurisdiction over the claims of these three plaintiffs. *See* Brief For The American Bar Association As Amicus Curiae ("ABA Br."), at 12 n.22; Brief Amicus Curiae of Banking and Business Lawyers, at 12 n.16. Pursuant to "the duty of this Court to see to it that the jurisdiction of the [district court] . . . is not exceeded," *City of Kenosha* v. *Bruno,* 412 U.S. 507, 511 (1973) (quotations omitted), the Court should order the claims of the three other plaintiffs dismissed.

rights. It also directly contravenes this Court's decisions holding that federal common law rules may not be created to supplement the rights or remedies Congress had adopted—especially where, as here, Congress itself has modified the statute over time to add appropriate remedies. See Pet. Br. 28-29 (citing five cases).

The other FDIC argument is based on the commonplace provision of the statute that grants the FDIC "such incidental powers as shall be necessary to carry out" the FDIC's express statutory powers. 12 U.S.C. § 1821(d)(2)(J). The FDIC's interpretation must be rejected because it obviously would make the specification of the FDIC's rights in Section 1821(d)(2)(A)(i) a "practical nullity." *United Sav. Ass'n* v. *Timbers of Inwood Forest Assocs.,* 484 U.S. 365, 375 (1988); *Jarecki* v. *G.D. Searle & Co.,* 367 U.S. 303, 307 (1961) (rejecting statutory interpretation of one provision that would swallow up other, narrower provision: "If there is a big hole in the fence for the big cat, need there be a small hole for the small one?") (internal quotations omitted).

Indeed, this Court has previously rejected the FDIC's proposed interpretation of the ubiquitous statutory provision that grants agencies "incidental" powers. In *Brannan* v. *Stark,* 342 U.S. 451 (1952), a statute specified the provisions that an agency could include in an order and added that the order could include auxiliary provisions "incidental to the enumerated terms and conditions." *Id.* at 463. The Court held that the agency's "incidental" authority could not be strained to include any matter of "basic importance" because Congress would not "hang one of the main gears on the tail pipe." *Id.* FDIC concedes that eliminating state-law requirements for a valid tort claim is a matter of fundamental importance. Moreover, the FDIC's claimed power to avoid requirements of state tort law is inconsistent with the express statutory provision that provides that the FDIC asserts the "rights . . . [and] powers . . . *of the insured depository institution.*" (Emphasis added.) Under *Brannan,* such an "inconsis-

tent" power "cannot be incidental to the enumerated" powers of the agency. 342 U.S. at 463.

In contrast to the irrelevant Section 1821(d)(2)(J), other statutory provisions provide strong support for holding that state law governs the tort issues in this case. See Pet. Br. 21-25. The FDIC does not dispute that in FIRREA Congress expressly departed from state law to create a number of federal rules of liability. The FDIC concedes that although Congress considered a variety of issues concerning appropriate remedies against savings and loan attorneys, see *id.* at 24 n.17, 27-28, none of the FIRREA statutory provisions that federalize an issue applies to the imputation issue in this case. This Court has repeatedly held that when, as here, Congress has legislated in an area and expressly created federal rules for certain issues, the Court will not create federal common law rules for other issues. See *id.* at 22 & n.15 (citing four cases); see also *Andrus* v. *Glover Constr. Co.*, 446 U.S. 608, 616-17 (1980) ("Where Congress explicitly enumerates certain exceptions to a general [rule], additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent.").

Similarly, the government ignores (FDIC Br. 46) that this Court has held that "[f]ederal courts lack authority" to create federal common law remedies that are "more stringent" than the administrative remedies enacted by Congress. *City of Milwaukee*, 451 U.S. at 320; see *Northwest Airlines*, 451 U.S. at 97-98. Indeed, even when the defendant's conduct violates a federal statute, the Court has repeatedly held that the presence of administrative remedies makes the Court "especially reluctant" to recognize an implied right of action creating a broader or different remedy. *E.g.*, *Karahalios* v. *National Fed'n of Fed. Employees*, 489 U.S. 527, 533 (1989). *A fortiori*, Congress' enactment here of administrative remedies *limited* to "reckless" attorney conduct is entirely inconsistent with what the government seeks—judicial creation

of federal tort rules for alleged conduct by petitioner that concededly would not violate any federal statute.[6]

II. UNDER *KIMBELL FOODS*, STATE LAW SUPPLIES THE RULE OF DECISION.

A. The FDIC Has Failed To Show A Need For A "Nationally Uniform Body of Law."

1. The FDIC does not dispute that in this case, and routinely in others, the FDIC seeks to mix aspects of state law[7] favorable to the agency with federal rules of deci-

[6] The FDIC also cites to the FIRREA statutory purpose "[t]o strengthen the enforcement powers of Federal regulators." § 101 (9), 103 Stat. 187 (1989). The FDIC omits that under FIRREA "enforcement powers" expressly refers to the administrative remedy provisions in Title IX, Subsection A, *see id.* at 446 *et seq.*, not to the "Conservatorship and Receivership Powers" of the FDIC under Section 212, *see id.* at 222.

[7] Contrary to the FDIC's suggestion (FDIC Br. 10), the Ninth Circuit did not hold that petitioner was negligent. The Ninth Circuit stated in dictum that lawyers have a general duty to investigate representations by a client's senior officers and owners, and that there was a question of fact whether petitioner had fulfilled this duty. *See* Pet. App. 8a-9a. Even if this Court affirms, the lower courts should be directed to reexamine this dictum because it contradicts a decision of the California Supreme Court issued *after* the Ninth Circuit's ruling. *See Bily* v. *Arthur Young & Co.*, 3 Cal. 4th 370, 397-98, 404-06, 834 P.2d 745, 761, 766-67 (1992) (in deciding professional duty, court must consider increased costs and decreased availability of services, as well as whether claimed benefits of duty have empirical support). *See, e.g.*, *Huddleston* v. *Dwyer*, 322 U.S. 232, 236 (1944) (remanding for consideration of subsequent state court decision that created "doubt"); *Vandenbark* v. *Owens-Illinois Glass Co.*, 311 U.S. 538, 543 (1941) ("until such time as a case is no longer *sub judice*, the duty rests upon federal courts to apply state law under the Rules of Decision statute in accordance with the then controlling decision of the highest state court"); *see also Miree* v. *DeKalb County*, 433 U.S. 25, 33 (1977) (remanding to apply state law and reexamine prior dicta).

The FDIC also misstates certain facts in its effort to show that petitioner was negligent. For example, Rogers & Wells did not undertake an "independent investigation" (FDIC Br. 7), but rather passively received information from Arthur Young and Touche

sion on issues where state law is unfavorable. See Pet. Br. 34-36. Nor does the FDIC dispute that this Court has held three times that such attempted mixing-and-matching is "intensely material" to rejecting a government agency's request for a federal rule of decision on a particular issue. *United States* v. *Yazell,* 382 U.S. 341, 346, 357 (1966); see Pet. Br. 34. The government's citation to *Boyle* v. *United Technologies Corp.*, 487 U.S. 500 (1988), is misplaced. In *Boyle,* the defendant sought a federal rule that would be dispositive of the state-law claims brought by the plaintiff. See *id.* at 514. Nothing in *Boyle* permits what the FDIC seeks here: that the same party be allowed to mix and match elements of state and federal law to create a hybrid claim or defense recognizable under neither. See Pet. Br. 26-28, 34-36.

2. The FDIC's contention that the law in the various states uniformly supports its position is simply not accurate. The Ninth Circuit proposed a rule under which imputation would not be permissible if the agent's conduct had ultimately caused loss to the company. See Pet. App. 12a, 15a. Petitioner has demonstrated that this proposed rule is contrary to the express decisions of the California courts, this Court, and state courts in general. Pet. Br. 37-41. As stated by the leading California Supreme Court case, there are "exceptions" under which the knowledge of an agent acting adversely to the principal is imputed to the principal—including when "the agent is in fact acting for his principal in the transaction, even though he may have an opposing personal interest." *McKenney* v. *Ellsworth*, 165 Cal. 326, 329, 132 P. 75, 76 (1913). That "exception" applies as a matter of law to this case because it is undisputed that Sahni and Day were the sole owners and controlled the management of ADSB, as well as the particular transactions at issue. See Pet. Br. 2-3,

Ross—information that was never supplied to petitioner. *See* E.R. 891-92, 910-28, 954-59, 3316-17. Indeed, *after* Touche Ross informed Rogers & Wells of ADSB's financial problems, Rogers & Wells permitted ADSB to close the Vineyard Way transaction without any change to the PPM. *See* Pet. Br. 6-7.

37-38; accord *Federal Land Value Ins. Co.* v. *Taylor*, 56 F.2d 351, 354 (9th Cir. 1932) (California law).[8]

The FDIC does not attempt to defend the Ninth Circuit's proposed federal tort rule. Rather, the FDIC invents two federal tort rules of its own. As part of its effort to distinguish numerous imputation decisions as applying only to commercial cases, the new rules fashioned by the FDIC are that imputation is impermissible when (1) the defendant is accused of negligence (see FDIC Br. 16, 25) or (2) the plaintiff represents an insolvent company (see *id.* at 18-19, 25-26). These newly proposed federal tort rules, however, suffer from the same defects as the Ninth Circuit's proposed rule: they are

[8] Petitioner does *not* concede that Sahni and Day were acting adversely to ADSB. When an agent's conduct brings money into the company, as here, this provides a short-term benefit and, even when there is longer-term detriment, the agent's conduct is not considered adverse to the company. *See FDIC* v. *Shrader & York,* 991 F.2d 216, 223-24 (5th Cir. 1993) (applying Texas law), *cert. pending*, No. 93-651; *Cenco Inc.* v. *Seidman & Seidman,* 686 F.2d 449, 456 (7th Cir.) (Illinois law), *cert. denied,* 459 U.S. 880 (1982); *Schneider* v. *Thompson,* 58 F.2d 94, 98 (8th Cir. 1932); *FDIC* v. *Deloitte & Touche,* 834 F. Supp. 1129, 1136 n.7, 1138-40 (E.D. Ark. 1992) (Arkansas law); *In re Wedtech Secs. Litig.*, 138 B.R. 5, 6, 9 (S.D.N.Y. 1992) (New York law); *Security Am. Corp.* v. *Schacht,* No. 82-C-2132 (N.D. Ill. 1983) (available on LEXIS) (Illinois law); *Seidman & Seidman* v. *Gee,* 625 So. 2d 1, 3 (Fla. Dist. Ct. App. 1992). Other courts have even more directly rejected the cause of action proposed by the FDIC and held that, without regard to imputation, the short-term benefit of bringing in money means that neither the corporation nor its successor can establish proximate cause, particularly in a negligence case. *See Bergeson* v. *Life Ins. Corp. of Am.*, 265 F.2d 227, 233-34 (10th Cir.) (Utah law), *cert. denied,* 360 U.S. 932 (1959); *Stratton* v. *Miller,* 113 B.R. 205, 210 (D. Md. 1989) (Maryland law), *aff'd,* 900 F.2d 255 (4th Cir. 1990); *see also Bloor* v. *Carro, Spanbock, Londin, Rodman & Fass,* 754 F.2d 57, 62 (2d Cir. 1985) (federal securities fraud law); *Rochelle* v. *Marine Midland Grace Trust Co.*, 535 F.2d 523, 528-29 (9th Cir. 1976) (same); *Johnson* v. *Chilcott,* 590 F. Supp. 204, 208-09 (D. Colo. 1984) (same); *Holland* v. *Arthur Andersen & Co.*, 571 N.E.2d 777, 782-83 (Ill. Ct. App. 1991) (fraud and breach of contract).

contrary to the express decisions of the California courts,[9] this Court, and other courts.

Flagg v. *Seng*, 16 Cal. App. 2d 545, 60 P.2d 1004 (1936), squarely holds that an outside professional can prevail in a *negligence* suit by a trustee for an *insolvent* corporation based on the imputed knowledge of those who control the corporation. *Id.* at 551, 60 P.2d at 1007; see also *Austin* v. *Hallmark Oil Co.*, 21 Cal. 2d 718, 728-29, 134 P.2d 777, 783-84 (Cal. 1943) (fraud of party was waived based on imputed knowledge of other party's corporate officers); *McKenney*, 165 Cal. at 327, 132 P. at 76 (imputation applied to receiver of failed bank). *Flagg* makes plain that when the controlling officers or directors have knowledge of that which the professional allegedly failed to discover and disclose, neither the corporation nor its successor can establish the necessary "causal relation." 16 Cal. App. 2d at 551, 60 P.2d at 1007. Specifically, the proximate cause element of a claim for professional malpractice requires justifiable reliance. *E.g.*, *Atari Corp.* v. *Ernst & Whinney*, 981 F.2d 1025, 1030 (9th Cir. 1992) (California law). In *Flagg*, as here, neither a

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[9] As requested by both parties, it is appropriate for this Court to make its own examination of California law. First, there is no doubt as to the correct result under California law. *E.g.*, *Bernhardt* v. *Polygraphic Co. of Am.*, 350 U.S. 198, 205 (1956); *see* Pet. Br. 37-39; *infra*, at pp. 10-11, 14. Second, this Court has determined state law for itself when a circuit court erroneously chose to apply federal law. *E.g.*, *West* v. *AT&T*, 311 U.S. 223, 238-39 (1940). Third, this Court determines the scope of state law where its scope may be pertinent to part of the Court's inquiry—here, the consistency of California law with the law of other states and prior federal law decisions. *See, e.g.*, *Gooding* v. *Wilson*, 405 U.S. 518, 524 (1972); *De Sylva* v. *Ballentine*, 351 U.S. 570, 580-82 (1956).

Contrary to the FDIC's new position (*see* FDIC Br. 15 n.3), it is clear that the court of appeals applied federal law to the issue of imputing the knowledge of Sahni and Day to ADSB. The Ninth Circuit's decision rested solely on federal cases, contradicted applicable California decisions, and stated that "[i]t is by now clear beyond doubt that federal, not state, law governs the application of defenses against FDIC." Pet. App. 11a-13a; *see* Pet. Br. 37-39; *infra*, at pp. 10-11, 14. The FDIC had previously and correctly informed this Court that the Ninth Circuit relied on *federal* law on this issue. *See* FDIC Br. on Pet. for Cert., at 3 n.2, 4.

corporation, nor its successor, can establish proximate cause because the persons in control of the institution "were . . . not deceived." 16 Cal. App. 2d at 551, 60 P.2d at 1007.[10] Even the FDIC cannot dispute that an allegedly negligent defendant may prevail when the plaintiff is unable to establish proximate cause.

Numerous cases applying the law of other states are in accord with *Flagg* that in a *negligence* case against a professional, imputation may properly be used to show that a receiver or trustee of an *insolvent* corporation cannot establish proximate causation or justifiable reliance. See, *e.g.*, *FDIC* v. *Ernst & Young*, 967 F.2d 166, 169 (5th Cir. 1992) (Texas law); *FDIC* v. *Deloitte & Touche*, 834 F. Supp. at 1138-40 (Arkansas law); *Begier* v. *Price Waterhouse*, 135 B.R. 222, 224 (E.D. Pa. 1991) (Pennsylvania law); *Stratton* v. *Sacks*, 99 B.R. 686, 692, 694 n.9 (D. Md. 1989), *aff'd*, 900 F.2d 255 (4th Cir. 1990) (Maryland law); *Gee*, 625 So. 2d at 3; see also *Bergeson*, 265 F.2d at 232 (Utah law in a derivative suit).[11]

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[10] The FDIC ignores its need to establish justifiable reliance, instead equating its very attenuated theory of but-for causation with proximate causation. *See* FDIC Br. 13-14. This failure to distinguish but-for causation from proximate causation is erroneous under both federal and California law. *See Holmes* v. *SIPC*, 112 S. Ct. 1311, 1317 (1992); *Girard* v. *Monrovia City Sch. Dist.*, 121 Cal. App. 2d 737, 742-43, 264 P.2d 115, 119 (1953). Equally erroneous is the government's remarkable statement that "the *allegations* of causation here must be taken as true on a motion for summary judgment." FDIC Br. 23 n.11 (emphasis added). *See, e.g.*, *Lujan* v. *Defenders of Wildlife*, 112 S. Ct. 2130, 2137 (1992); *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 319, 322-24 (1986).

Even if the issue were denominated estoppel, California law plainly would permit an allegedly negligent party to raise imputation. *See Austin*, *supra*. Other States are in accord. *See Lettieri* v. *American Sav. Bank*, 437 A.2d 822, 827-28 (Conn. 1980); *Crystal Ice Co.* v. *First Colonial Corp.*, 257 S.E.2d 496, 498 (S.C. 1979); *Sussel* v. *First Fed. Sav. & Loan Ass'n*, 238 N.W.2d 625, 628 (Minn. 1976); *see also FDIC* v. *Shrader & York*, 991 F.2d at 226 (Texas law permits imputation absent "collusion").

[11] Cases relied on by the FDIC involve claims of fraud against the defendant for actively causing or concealing the institution's

This Court too has held that a so-called "wrongdoer" (to use the FDIC's label) may prevail against a receiver based on imputation. In *Deitrick* v. *Standard Sur. & Cas. Co.*, 303 U.S. 471 (1938), a pre-*Erie* case, an entity that committed fraud prevailed over the receiver of a failed national bank based on the imputation to the bank of the knowledge of the bank's own fraudulently acting agent. *Id.* at 478-81; see also *Armstrong* v. *Ashley*, 204 U.S. 272, 278, 283 (1907) (receiver). *Standard Surety* thus squarely contradicts both of the FDIC's proposed federal rules of decision. See *supra* at p. 9.[12]

Standard Surety also forecloses the FDIC's argument that a receiver may avoid imputation simply by invoking the interests of creditors. See FDIC Br. 18, 26. *Standard Surety* holds that to make such an argument, at a minimum, the receiver must plead and then prove the elements of specific creditors' claims, including that the defendant acted to "mislead creditors" and the "damages" sustained by the creditors. 303 U.S. at 480.[13]

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insolvency. *See* FDIC Br. 17-18, 27 n.14. There is authority to the contrary when the defendant is an outside professional. *See Cenco*, 686 F.2d at 454; *Feltman* v. *Prudential Bache Secs.*, 122 B.R. 466, 474 n.9 (S.D. Fla. 1990) (Florida law); *Security Am. Corp.* v. *Schacht*, *supra*. In any event, cases where the defendant is sued for fraud are inapposite because the reach of proximate cause is potentially broader for fraud than for negligence. *See, e.g.*, *Tate* v. *Canonica*, 180 Cal. App. 2d 898, 904, 5 Cal. Rptr. 28, 33 (1960); Restatement (Second) of Torts § 435B & cmt. a (1965). Here, the FDIC concedes that it does not even allege fraud by petitioner, nor that petitioner caused or was aware of ADSB's insolvency. *See* FDIC Br. 13, 33.

[12] If federal rules of decision do apply to this case, prior decisions of this Court such as *Deitrick*, *Armstrong*, and others (*see* Pet. Br. 40) would supply those rules. *See Clearfield Trust Co.* v. *United States*, 318 U.S. 363, 367 (1943) (applying pre-*Erie* federal common law). Under those decisions, petitioner prevails.

[13] The FDIC's citation to *McCandless* v. *Furlaud*, 296 U.S. 140 (1935), a pre-*Erie* suit against officers for fraud, is misplaced because *McCandless* "clearly emphasizes that the receiver in that case was suing on behalf of the corporation not third parties; he was simply stating the same claim that the corporation could have

Here, the FDIC has never alleged or proved the elements of a claim by any depositor, as *Standard Surety* requires.[14] This is not surprising; no depositor could satisfy either of the requirements of proximate causation and privity that apply under both California and federal law.[15]

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made had it brought suit prior to entering receivership." *Caplin* v. *Marine Midland Grace Trust Co.*, 406 U.S. 416, 429 (1972).

[14] Moreover, under the current statute, the FDIC succeeds to the "rights . . . of any . . . depositor . . . *with respect to the institution and the assets of the institution.*" 12 U.S.C. § 1821(d)(2)(A)(i) (emphasis added). The emphasized language means that the FDIC succeeds only to the rights of depositors to bring derivative suits to enforce claims of the institution, not to any direct claims of depositors. *See* Pet. Br. 19-20 n.12.

[15] A creditor cannot establish proximate causation because, as a matter of law, there is no direct relation between the creditor's loss and conduct allegedly causing an injury to the insolvent debtor. *See Holmes* v. *SIPC*, 112 S. Ct. at 1317-20 & n.19; *see also Girard*, 121 Cal. App. 2d at 742, 264 P.2d at 119 ("direct" causation required). In addition, no depositor could establish the basis necessary under California law for a nonclient to sue an attorney: knowledge by the attorney that the depositor would receive and justifiably rely on the attorney's advice. *See Bily*, 3 Cal. 4th at 392, 406-07, 410-11 & n.18, 413, 834 P.2d at 757-58, 767, 769-70 & n.18, 772; *Goodman* v. *Kennedy*, 18 Cal. 3d 335, 344, 556 P.2d 737, 743 (1976). Federal law has an even stricter privity requirement. *See Savings Bank* v. *Ward*, 100 U.S. 195, 200-06 (1880); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214-16 n.33 (1976).

Any privity rule more relaxed than California's would frequently place the attorney in a position of conflict of interest, would threaten the disclosure of privileged attorney-client communications, would "inject undesirable self-protective reservations into the attorney's counselling role," and would result in both "an undue burden on the profession and a diminution in the quality of the legal services received by the client." *Goodman*, 18 Cal. 3d at 344, 556 P.2d at 743 (citation and quotations omitted); *accord Sheldon Appel Co.* v. *Albert & Oliker*, 47 Cal. 3d 863, 882-83, 765 P.2d 498, 509 (1989) (nonclient may not sue attorney for inadequate investigation because this "would tend to create a conflict of interest between the attorney and client, tempting a cautious attorney to create a record of diligence . . . , not for the benefit of the client, but simply to protect himself" from a lawsuit by the nonclient). The FDIC's proposed federal tort rules would effectively

3. Finally, even if there were a split in state law on applicable imputation principles, this would not show an adequate "need for a nationally uniform body of law." *United States* v. *Kimbell Foods*, 440 U.S. 715, 728 (1979). Indeed, in *Yazell*, the Court refused to create a uniform federal rule to replace a Texas rule—coverture—that was "peculiar and obsolete," had been repealed prospectively in Texas, and was followed by only one other state. 382 U.S. at 351 & n.23.

The FDIC's argument for "need" boils down to this: Because federal receivers and bankruptcy trustees do not sue often enough in state court, federal courts will have difficulty ascertaining what applicable state law would be. FDIC Br. 28-31. This argument suffers from at least four fatal defects. First, the FDIC's premise is refuted by this very case. Each of the Ninth Circuit's and the FDIC's three proposed rules of decision is squarely refuted by California cases on point. See, *e.g.*, *Flagg* (loss to company; negligence by defendant; bankruptcy trustee); *McKenney* (loss; receiver); *Austin* (fraud).

Second, the FDIC's premise is refuted by federal court decisions too numerous to recite that have applied state imputation principles in cases brought by receivers or bankruptcy trustees. See *supra* at pp. 9 n.8, 11-12 & n.11, for citations to 10 such cases. Indeed, the *Ninth Circuit* has applied California imputation law to tort claims by bankruptcy trustees. See *In re Wolverton Assocs.*, 909 F.2d 1286, 1297 n.7 (9th Cir. 1990); see also *McKee* v. *American Cas. Co.*, 316 F.2d 428, 430 (5th Cir. 1963); Pet. Br. 21.

Third, federal court jurisdiction over tort suits by the FDIC and bankruptcy trustees is concurrent, not exclusive. See 12 U.S.C. § 1819; 28 U.S.C. § 1334(b). FDIC receivers and bankruptcy trustees can and do sue attorneys and auditors in state courts. See, *e.g.*, *Flagg; FDIC* v. *High Tech Medical Sys.*, 574 So. 2d 1121 (Fla. Dist.

create implied duties from attorneys to the savings and loan's creditors and regulators and thus would have precisely these detrimental effects. *See* Pet. Br. 29, 47-48; ABA Br. 3-4.

Ct. App. 1991); *Holland* v. *Arthur Andersen & Co.*, 571 N.E.2d 777 (Ill. Ct. App. 1991). Insurance liquidators and state-appointed receivers for insolvent corporations also sue in state courts. See, *e.g.*, *McKenney; Gee*, 625 So. 2d 1. Thus, state courts have ample opportunities to address issues of the kind raised in this case.

Fourth, federal courts routinely fulfill their duty "to make [their] own determination of what the [highest state court] would probably rule in a similar case" when, unlike here, there is no applicable ruling from the state courts. *King* v. *Order of United Commercial Travelers*, 333 U.S. 153, 161 (1948).[16] If accepted by this Court, the government's argument that difficulty in ascertaining state law provides a basis for creating a substantive federal rule of decision could easily result in an exception to the principles of *Erie R.R.* v. *Tompkins*, 304 U.S. 64 (1938), that swallows the rule. Such an expansion of federal common law would be antithetical to this Court's commitments to both separation of powers and federalism. At bottom, the FDIC's argument is no more than a thinly-disguised restatement of the argument rejected in *Erie* and ever since that the creation of federal court jurisdiction "in and of itself give[s] rise to authority to formulate federal common law." *Texas Indus.* v. *Radcliff Materials, Inc.*, 451 U.S. 630, 640-41 (1981).

FDIC's "need" argument does reveal, however, the enormous burden that "creating a judicial substitute" for state law would place on the federal courts, thus providing further support for not doing so. *Wallis* v. *Pan Am. Petroleum Corp.*, 384 U.S. 63, 68 (1966). The FDIC bases its "need" argument on its assertions that the FDIC is an "involuntary" transferee and that its potential liability greatly exceeds the stockholders' equity. FDIC Br. 29-30.[17] These arguments apply equally to bankruptcy trust-

[16] Moreover, 38 states allow certification of state law issues from federal courts to the state's highest court. *See* 17A C. Wright, A. Miller & E. Cooper, *Federal Practice and Procedure* § 4248, at 167-68 & nn.30-31 (2d ed. 1988 & Supp. 1993).

[17] The FDIC ignores its own invocation of the interests of creditors, who have engaged in "voluntary" transactions, and the

ees, SIPA trustees, and indeed every trustee, receiver, and liquidator. FDIC Br. 26 (bankruptcy trustees are "comparable"). If the FDIC is entitled to a special immunity from state law, each of these entities will also ask this Court for similar treatment—indeed, that process has begun. See Brief Amici Curiae of SIPC, *et al.*

Even if the federal courts can sort out which plaintiffs get special rules, the lower courts (and, inevitably, this Court) will face the task of deciding issue-by-issue when to create a federal tort rule and what the rule should be. The FDIC's expansive rationale for according it immunity from state law—that its interests are different from state court litigants—by its own logic applies to every issue in a tort suit, as the FDIC's arguments in this Court and the lower courts reveal. See FDIC Br. 41; Pet. Br. 41 & n.29. As it has before, the Court should decline the government's request that the federal courts create an expanding series of federal rules of decision "on a case-by-case basis." *Kimbell Foods*, 440 U.S. at 739 n.42; accord *City of Milwaukee*, 451 U.S. at 325 (refusing to create federal common law on "ad hoc" basis).

B. Application Of State Law Would Not Frustrate Specific Objectives Of The Federal Program.

The FDIC devotes most of its argument that state law would frustrate specific objectives of the federal program to the argument that a federal rule would allow the agency to obtain more money. FDIC Br. 32-33, 44. The FDIC makes no attempt to distinguish the prior cases of this Court rejecting precisely such a "more money" argument. See Pet. Br. 42-43. To the contrary, the FDIC's discussion effectively concedes that the two factors that underlie the rejection of this argument by *Kimbell Foods* are present here. Thus, the FDIC concedes that the statutory scheme provides the government

unique array of statutory powers that regulators have to limit the FDIC's potential liability, including periodic examinations, limitations on asset growth, increases in capital and insurance premiums, and withdrawal of insurance. *See* Pet. Br. 44-45.

with "substantial power to regulate insured institutions and to determine whether to insure an institution" and thus to protect its financial interests. FDIC Br. 29-30 n.16; see Pet. Br. 44-45. And the FDIC does not dispute that the federal statutory scheme is primarily designed not to maximize federal recoveries, but to encourage lending transactions that might not otherwise occur. See FDIC Br. 11, 30-31; Pet. Br. 45-46. Under these precise circumstances, *Kimbell Foods* holds that it is inappropriate to create a federal rule of decision. See 440 U.S. at 735-37, 739 & n.43.[18]

The sole other objective asserted by the FDIC is the provision by lawyers of "diligent service." FDIC Br. 32. The abrogation of traditional state law imputation principles, however, would more likely lead to fewer services, provided at higher cost, by lawyers willing to take greater risks, as well as other adverse consequences. See Pet. Br. 29-30, 45-46; *supra*, at p. 13 n.15.[19] Moreover, at a minimum, the burden is on the FDIC to show frustration of a *specific* objective found in the "express provisions" of the statute. *Kamen* v. *Kemper Fin. Servs.*, 111 S. Ct. 1711, 1717 (1991); accord, *e.g.*,

[18] The *government's own estimate* of the amount of the claims affected by the issues herein—a figure that assumes no litigation costs, victory for the government on all other issues, and full collection on all judgments—is *less than one percent* of the total estimated loss from failed savings and loans. *Compare* FDIC Br. on Pet. for Cert., at 5 (No. 93-489), *with* National Commission on Financial Institution Reform, Recovery and Enforcement, *Report to the President and Congress of the United States*, at 4 (July 1993). *See also* Pet. Br. 36-37 n.27.

[19] The FDIC is simply wrong when it asserts that traditional imputation principles somehow leave a lawyer better off when the client's officers commit fraud. *See* FDIC Br. 32-33. If the officers are without fault, the lawyers cannot be sued at all for allegedly failing to uncover officer misconduct. And, if an officer is negligent, the knowledge of the officer is more easily imputed—*e.g.*, without a showing of control or benefit to the company—than if the officer acts fraudulently. *See, e.g.*, *FDIC* v. *Ferguson*, 982 F.2d 404, 406-07 (10th Cir. 1991); *Stratton* v. *Sacks*, 99 B.R. at 694.

Kimbell Foods, 440 U.S. at 728, 735, 738; *cf. Board of Governors* v. *Dimension Fin. Corp.*, 474 U.S. 361, 373-74 (1986) ("Invocation of the 'plain purpose' of legislation at the expense of the terms of the statute itself takes no account of the processes of compromise and, in the end, prevents the effectuation of congressional intent."). Attorney "diligence" is simply not a "specific" objective of the statute, and the statute provides no guidance on what constitutes such "diligence" or what defenses to recognize when an attorney has allegedly not been diligent. The statute enacted by Congress deliberately goes no further than "reckless" attorney conduct, and even then does not create a federal cause of action or eliminate traditional defenses. See Pet. Br. 27-28, 45. Congress deliberately left professional "malpractice" issues to state law. H.R. Rep. No. 54(I), *supra*, at 415. The policy arguments on whether federal law instead should supersede state law when the FDIC sues an attorney for malpractice, "regardless of the merits of the conflicting arguments, . . . is a matter for Congress, not the courts, to resolve." *Texas Indus.*, 451 U.S. at 646-47.

C. Creation Of A Uniform Federal Rule Of Decision Would Severely Disrupt Commercial Relationships Predicated On State Law.

Although both tort law and the regulation of lawyers are quintessential matters of state law, the FDIC contends that petitioner could not reasonably have expected state law to govern its potential tort liability to its client. The FDIC asserts that no law firm or malpractice insurer could reasonably base its conduct or business on the possibility of a "windfall defense" such as imputation and, moreover, such entities could not be surprised that the later appointment of a federal receiver altered their rights and obligations under state law. FDIC Br. 34.

In deciding whether to offer or insure certain services, however, firms and insurers do consider the full range of issues bearing on a law firm's potential liability, including proximate causation as well as the availability and relative strength of affirmative defenses. The FDIC's contention

to the contrary is counter-intuitive and counter to a number of decisions of this Court. See, *e.g.*, *American Dredging Co.* v. *Miller*, 62 U.S.L.W. 4130, 4134 (U.S. Feb. 23, 1994) (noting that "affirmative defenses such as contributory negligence (which eliminate liability)" are rules "upon which . . . actors rely in making decisions about primary conduct—how to manage their business and what precautions to take"). The FDIC's attempt to dismiss imputation and defenses in general as mere "windfalls" ignores the fact that any determination of liability depends on the interplay of issues such as duty, reliance, proximate causation, and affirmative defenses. Here, for example, the requirement of California law that the FDIC must prove justifiable reliance by ADSB, petitioner's client, sets a reasonable and necessary limit on the potential liability arising from the novel and dubious duty posited by the Ninth Circuit of an attorney to investigate facts furnished by the client. See Pet. Br. 34-35 nn.24-25.

States have a "paramount" interest in balancing the competing policy considerations that underlie issues of duty, reliance, proximate cause, and the other elements that collectively define the extent of tort liability. *Martinez* v. *California*, 444 U.S. 277, 282-83 (1980); *Ferri* v. *Ackerman*, 444 U.S. 193, 198 (1979) ("when state law creates a cause of action, the State is free to define the defenses to that claim, including the defense of immunity" in a legal malpractice action). When federal courts change these rules after the fact, they upset the balance the States have struck and the settled and reasonable expectations of entities that have relied on state law.[20]

The FDIC contends, however, that petitioner could not have expected state law to govern its tort liability to its client because it should have anticipated (1) that ADSB

[20] *Cf. Pinter* v. *Dahl*, 486 U.S. 622, 654 n.29 (1988) (expanding liability of professionals "risks over-deterring activities related to lawful" transactions); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. at 214-16 n.33 (increasing the " 'hazards' " of professional services raises "serious policy questions" best left to Congress).

might become insolvent, (2) that, in the event of insolvency, a federal receiver would be appointed, *and* (3) that the presence of a receiver would alter petitioner's rights and obligations under state law. FDIC Br. 34. The short answer to this fanciful contention is that, prior to the enactment of FIRREA, a host of federal decisions dating back well before the conduct in this case had held that state law supplied the rule of decision applicable to tort claims asserted by receivers for failed banks and savings and loans. Pet. Br. 25 n.19. Indeed, FIRREA simply confirmed the expectation that state law governs a law firm's rights and obligations vis-a-vis its thrift client both before *and* after appointment of a federal receiver. See *supra*, at pp. 1-2, 4-7.

Accordingly, applying a federal rule of decision to determine a law firm's tort liability to its client indisputably disrupts commercial relationships and expectations predicated on state law. The FDIC has not overcome the "presumption," which the Court has stated is "particularly strong" in this context, that state law applies. *Kamen*, 111 S. Ct. at 1717; see also *Patterson* v. *McLean Credit Union*, 491 U.S. 164, 183 (1989) ("as a rule we should be and are 'reluctant to federalize' matters traditionally covered by state common law").

CONCLUSION

The judgment of the Ninth Circuit should be reversed.

Respectfully submitted,

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March 4, 1994

No. 93-489

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

O'MELVENY & MYERS,
Petitioner,
v.
FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR LEE H. HENKEL III AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

The petition presents two questions, one of which acts as the analytical steppingstone for consideration of the other:

1. Whether state law provides the relevant substantive standards for evaluating equitable defenses to state-law tort claims made by an insolvent thrift.

2. If state law would govern such defenses in that context, whether, notwithstanding that fact, those defenses must be evaluated under different federal substantive standards when the same tort claims are made not by the thrift but by a federal receiver.

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BRIEF FOR LEE H. HENKEL III AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF THE *AMICUS CURIAE*

This Court granted review in this case in response to the parties' representations that the decision below conflicts with the decision in *FDIC v. Shrader & York*, 991 F.2d 216 (5th Cir. 1993), petition for cert. pending, No. 93-651. *Amicus* Lee H. Henkel III is a respondent in *Shrader & York* and has filed a brief in opposition to the petition for a writ of certiorari in that case. Because the parties, albeit incorrectly, have linked the two cases, Henkel's interest here is manifest. Both parties have consented to the filing of this brief.

ARGUMENT

The parties in this case contend that the decision of the Ninth Circuit below conflicts with that of the Fifth Circuit in *FDIC v. Shrader & York*, 911 F.2d 216 (5th Cir. 1993), petition for cert. pending, No. 93-651. A close comparative analysis of the two cases, therefore, should assist the Court in its consideration of the issues the parties have asked it to decide. This analysis reveals, *inter alia*, that there is in fact no true conflict because the cases present conceptually distinct issues.

In broad outline, of course, the two cases are quite similar. In each case the Federal Deposit Insurance Corporation ("FDIC") has sued a law firm contending that the firm is liable for malpractice in the representation of one or more now-insolvent thrift institutions. In each case the defendant law firm has asserted a defense that might or would have been successful against the thrifts themselves. The thrust of the government's argument in each case is that federal law "protect[s] federal receivers against claims and defenses that might have been successful against the institution." *Shrader & York* Pet. 5. Thus each case can be analytically broken down into two components: (1) would the law firm's defense be good as against the thrift? (2) if so, does it nevertheless fail as against the FDIC?

Although the two cases resemble one another in these general ways, in their particulars they are quite different. To begin with, it is undisputed that in *O'Melveny* the FDIC is acting as the receiver of the insolvent thrift, and the government contends that a receiver represents "the entire community of interests in the corporation—creditors as well as stockholders." *Pepper v. Litton*, 308 U.S. 295, 307 (1939) (describing those to whom a corporate director owes a fiduciary duty). In contrast, it is undisputed that in *Shrader & York* the FDIC is acting not as a receiver but rather as an assignee of the insolvent thrift. *See Shrader & York* Pet. 2 n.1. Thus in *Shrader & York*, as in *FDIC v. Ernst & Young*, 967 F.2d 166, 169 (5th Cir. 1992), "the FDIC's decision to sue only as . . . assignee" rebutted the essential factual predicate on which its legal argument was based.

The government suggests that the distinction between a receiver and an assignee should be disregarded in this context. *See Shrader & York* Pet. 5 n.2. Yet this Court has expressly held that when the federal government acts as an assignee it stands in the assignor's shoes and is subject to the same defenses. *Dietrick v. Standard Surety & Cas. Co.*, 303 U.S. 471, 479-80 (1938). If indeed there is no difference between a receiver and an assignee, it is evident, without the need of any further analysis, that the FDIC is wrong not only in *Shrader & York* but in *O'Melveny* as well.

The two cases also differ significantly in their operative facts and in the nature of the defenses asserted by the respective defendant law firms. In *O'Melveny*, the FDIC claims that the firm committed malpractice by failing to uncover and disclose fraudulent acts by the thrift's insiders. The law firm contends that the insiders' fraudulent acts were attributable to the thrift itself; that the thrift could not recover for a failure to uncover and disclose its own acts; and that the FDIC, acting in the capacity as the thrift's receiver, is subject to the same disability. (The Ninth Circuit characterized this defense as one of equitable estoppel. Whether that characterization is accurate is by no means clear. We adopt it here merely to meet the court's reasoning on its own terms.)

In *Shrader & York*, the FDIC claims that the firm committed malpractice by failing to advise the thrifts that certain commercial transactions required prior regulatory approval. The law firm asserts a limitations defense, contending that the statute of limitations began to run when the thrifts knew or should have known the facts establishing the causes of action; that an insider knew those facts no later than 1985 and that his knowl-

edge was attributable to the thrifts; and that the applicable two-year statute of limitations therefore had run before the thrifts became insolvent in 1988 and their remaining assets and claims were assigned to the FDIC.

In the end, the defendant law firm is right, and the FDIC is wrong, in both of these cases. But the paths of legal reasoning in the two cases necessarily diverge, reflecting the different facts and legal issues that each case presents.

I. STATE LAW PROVIDES THE RELEVANT SUBSTANTIVE STANDARDS FOR EVALUATING DEFENSES TO STATE-LAW TORT CLAIMS MADE BY AN INSOLVENT THRIFT

In considering whether the law firm's defense would have been good as against the thrift, the Ninth Circuit in *O'Melveny* was inattentive to the matter of choice of law. The court began with "the unexceptionable general principle that the perpetrator of a fraud cannot be a victim of that fraud." *O'Melveny* Pet. App. 10a. This meant, as the court understood, that the thrift would have been estopped from suing the law firm for malpractice if the insiders' fraud could be attributed to the thrift. *Id.* The court further understood that, under California law, the insiders' fraud would be attributed to the thrift unless the insiders actually had been acting adversely to the thrift. *Id.* at 11a. But in proceeding to consider whether the facts established such adverseness, the court made no attempt to determine and follow California legal principles and decisional law. Instead, the court fashioned what can only be described as a federal common law rule that has nothing to do with actual adverseness. The court reasoned that "insiders' conduct is . . . not attributable to the corporation if a recovery by a plaintiff would serve the objectives of tort liability by properly compensating the victims of the wrongdoing and deterring future wrongdoing." *Id.* at 12a. Numerous California cases seemingly to the contrary were cited only to be distinguished on their facts. *Id.* at 12a n.7, 13a n.8. Apparently believing

that a recovery by the thrift would have served "the objectives of tort liability," the Ninth Circuit concluded that the insiders' wrongdoing should not be attributed to the thrift and that the thrift itself therefore would not have been vulnerable to a defense of equitable estoppel. *Id.* at 10a.

It is by no means clear that the Ninth Circuit deliberately substituted federal common law in place of California law in considering whether a defense of equitable estoppel would have prevailed against the thrift. Certainly the court did not acknowledge that that was what it was doing. On the other hand, it is plain that the court was not conscientiously applying California law. In contrast, in evaluating the limitations defense in *Shrader & York* the Fifth Circuit carefully applied state law.

Although the acts of alleged malpractice in *Shrader & York* all had occurred during or prior to 1985, suit was not brought until 1991. *Shrader & York* Pet. App. 3a, 26a. The Fifth Circuit noted that "[t]he Texas limitation period for malpractice claims is two years," *id.* at 7a, and that under Texas law "the limitations period on legal malpractice begins to run when 'the claimant discovers or should have discovered through the exercise of reasonable care and diligence the facts establishing the elements of his cause of action.'" *Id.* at 10a, quoting *Willis v. Maverick*, 760 S.W.2d 642, 646 (Tex. 1988). It was undisputed that an insider had contemporaneous knowledge of such facts, and the court noted that in Texas the knowledge of corporate insiders is imputed to the corporation "to determine when the statute of limitations began to run." *Id.* at 12a, citing *Alice Roofing & Sheet Metal Works, Inc. v. Halleman*, 775 S.W.2d 869 (Tex. App. 1989). The court acknowledged that in Texas, as elsewhere, "courts will generally not impute a bank officer or director's knowledge to the bank if the officer or director acts with an interest adverse to the bank." *Id.* at 15a. In order to identify the proper standard of adverseness,

the court expressly looked to Texas decisional law. *Id.* at 16a-17a, discussing *Goldstein v. Union Nat'l Bank*, 213 S.W. 584 (Tex. 1919). Applying that standard, the court determined that (with a single exception not here relevant) the knowledgeable insider had not been acting adversely and his knowledge therefore was attributable to the thrifts. *Id.* at 20a-23a. Accordingly, the Fifth Circuit concluded that the statute of limitaitons had run long before the lawsuit was initiated. *Id.* at 10a. It follows that if the thrifts, rather than the FDIC, had brought suit in 1991, their suit unquestionably would have been barred.

The Fifth Circuit's careful invocation of state law in *Shrader & York* was exemplary. It is beyond serious dispute that state law governs a thrift's claim against a law firm for malpractice. *See Bank of America Nat'l Trust & Savings Ass'n v. Parnell*, 352 U.S. 29, 33-34 (1956). The assertion of such a state-law tort claim in purely private litigation simply does not implicate the sort of "uniquely federal interests," *Texas Industries, Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 640 (1981), quoting *Banco Nacional de Cuba v. Sabatino*, 376 U.S. 398, 426 (1964), that on rare occasions have been held to warrant the replacement of state law with judge-made federal common law. *See, e.g., Boyle v. United Technologies Corp.*, 487 U.S. 500 (1988). Indeed, in *O'Melveny* the Solicitor General apparently has conceded, by not arguing the contrary, that state law would govern the viability of the law firm's defense as against the thrift itself. The Solicitor General further appears to recognize, for he does not contend otherwise, that under California law the law firm's defense indeed was good against the thrift.

II. STATE LAW ALSO PROVIDES THE RELEVANT SUBSTANTIVE STANDARDS FOR EVALUATING DEFENSES TO STATE-LAW TORT CLAIMS MADE BY A FEDERAL RECEIVER OF AN INSOLVENT THRIFT

Shifting the focus from the rights of the thrift to those of the FDIC in its capacity as receiver, the Ninth Circuit in *O'Melveny* understood the question to be whether an equitable defense good against the thrift nevertheless would fail against the FDIC. The court concluded, relying in part on *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), that as a matter of federal common law the FDIC was not tarred by the thrift's wrongdoing. In reaching this result, the court expressly refused to "incorporate state law to provide the federal rule of decision." *O'Melveny* Pet. App. 13a-14a. Instead, the court purported to "establish federal law," *id.* at 14a, based upon its perception that "the equities between a party asserting an equitable defense and a bank are at such variance with the equities between the party and a receiver of the bank that equitable defenses good against the bank should not be available against the receiver." *Id.* at 15a.

The legal setting in *Shrader & York* is very different. The issue there turns on whether, in a suit brought by the FDIC as assignee, federal law supplants a state statute of limitations or otherwise serves to revive stale claims. The rule in this situation is clear: if a claim held by an assignor is time-barred by applicable local law prior to its assignment to the federal government, it remains time-barred in the hands of the United States as assignee. *Guaranty Trust Co. v. United States*, 304 U.S. 126, 141-43 (1938). The federal government acquires by assignment only "whatever rights then survived the running of the statute against" its assignor. *Id.* at 141.

This result was not changed by the Financial Institutions, Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), Pub. L. 101-73, 103 Stat. 187. Section 11

of the Federal Deposit Insurance Act, 12 U.S.C. § 1821 (d)(14), was amended by FIRREA to read in pertinent part as follows:

> (A) . . . the applicable statute of limitations with regard to any action brought by the [FDIC] as as conservator or receiver shall be—
>
> . . .
>
> (ii) in the case of any tort claim, the longer of—
>
> (I) the 3-year period beginning on the date the claim accrues; or
>
> (II) the period applicable under State law.
>
> (B) . . . the date on which the statute of limitation begins to run on any claim described in . . . subparagraph [(A)] shall be the later of—
>
> (i) the date of the appointment of the [FDIC] as conservator or receiver; or
>
> (ii) the date on which the cause of action accrues.

This provision by its express terms applies only when the FDIC brings suit "as conservator or receiver." It thus has no application to suits brought by the FDIC in the capacity of an assignee. Notwithstanding the enactment of FIRREA, therefore, when the FDIC sues as assignee, as in *Shrader & York*, the rule indisputably remains as stated in *Guaranty Trust*: if the claim was time-barred in the hands of the assignor, it likewise is time-barred in the hands of the federal assignee.

Section 11, as amended, would not have availed the FDIC in *Shrader & York* even if it had been acting, as in *O'Melveny*, as a receiver. This is so for two reasons. *First*, the thrifts' claims in *Shrader & York* all had expired no later than 1987, two years prior to the enactment of FIRREA. It is undisputed that, whatever else it may do, FIRREA does not revive claims that were time-barred

before its enactment. The Fifth Circuit's holding on this issue reflects the rule that "[i]n the absence of a contrary legislative purpose, 'subsequent extensions of a statutory limitation period will not revive a claim previously barred.'" *Village of Bellwood v. Dwivedi*, 895 F.2d 1521, 1527 (7th Cir. 1990), quoting *Davis v. Valley Distributing Co.*, 522 F.2d 827, 830 (9th Cir. 1975). Because no such contrary legislative purpose is expressed in FIRREA, the courts that have considered the matter are unanimous in ruling that FIRREA does not operate retroactively to revive claims that expired before 1989. *See, e.g.*, *FDIC v. Belli*, 981 F.2d 838, 842 (5th Cir. 1993). The Solicitor General quite properly does not challenge this settled construction of the statute in his petition for certiorari in *Shrader & York*.

Second, section 11 could not, in any event, reasonably be construed as reviving *any* claims, including claims (unlike those in *Shrader & York*) that expired after enactment of FIRREA in 1989 but before the FDIC's appointment as an insolvent thrift's conservator or receiver. The effect of section 11 is only to extend the period of limitations with respect to claims that were viable when the FDIC acquired them, in order to provide the FDIC ample time to review the insolvent thrift's affairs and determine a course of action. Section 11 does not revive claims that had expired before the thrift became insolvent. On this point as well, the lower courts, including both the Fifth and Ninth Circuits, are unanimous. *See, e.g.*, *Randolph v. RTC*, 995 F.2d 611, 619 (5th Cir. 1993), petition for cert. pending, No. 93-955; *FDIC v. McSweeney*, 976 F.2d 532, 534 (9th Cir. 1992), *cert. denied*, 113 S. Ct. 2440 (1993).

Before the enactment of FIRREA, the courts properly understood, and stated in numerous cases involving the FDIC, that time-barred claims may not be revived through the legerdemain of federal common law. As the Ninth Circuit explained,

> It is settled law that state limitations statutes are relevant in determining a claim's viability at the time the federal agency acquires the claim. If the state statute of limitations has expired before the government acquires a claim, that claim is not revived by transfer to a federal agency.

FDIC v. Former Officers & Directors of Metro. Bank, 884 F.2d 1304, 1309 n.4 (9th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990). In short, "stale claims may not be revived by transfer to a federal agency." *FDIC v. Regier Carr & Monroe*, 996 F.2d 222, 225 (10th Cir. 1993). *Accord, e.g.*, *FDIC v. Hinkson*, 848 F.2d 432, 434 (3d Cir. 1988).

Clear as this rule was prior to the enactment of FIRREA, it is even more so now. "[O]nce Congress addresses a subject, even a subject previously governed by federal common law, the justification for lawmaking by the federal courts is greatly diminished. Thereafter, the task of the federal court is to interpret and apply statutory law, not create common law." *Northwest Airlines, Inc. v. Transport Workers Union*, 451 U.S. 77, 95 n.34 (1981). It would have been a grave step, and one arguably of dubious constitutionality, if Congress had purported to revive state-law tort claims that had become time-barred under state law. Statutes of limitations "represent a pervasive legislative judgment that it is unjust to fail to put the adversary on notice to defend within a specified period of time and that 'the right to be free of stale claims in time comes to prevail over the right to prosecute them.'" *United States v. Kubrick*, 444 U.S. 111, 117 (1979), quoting *Railroad Telegraphers v. Railway Express Agency*, 321 U.S. 342, 349 (1944). Recognizing this, Congress in FIRREA stopped short of reviving stale claims and acted only to extend the period of limitations with respect to viable claims. Congress having struck this balance, no room is left for judicial imposition of a federal common law rule that would be more invasive and disruptive of state law. *See Halcyon Lines v. Haenn Ship Ceiling & Refitting Corp.*, 342 U.S. 282, 287 (1952) ("because Congress while acting in the field has stopped short of approving the rule . . . here urged, we think it would be inappropriate for us to do so").

D'Oench, Duhme, the case upon which the Ninth Circuit relied in *O'Melveny*, and upon which the Solicitor General relies in *Shrader & York*, obviously does not independently authorize or justify the imposition of a federal common law rule that would revive tort claims that were time-barred by state law prior to their transfer to the FDIC. In *D'Oench, Duhme* and its precursor, *Dietrick v. Greaney*, 309 U.S. 190 (1940), the Court was concerned with the problem created when a bank and the accommodation maker of a note enter into a secret agreement, not reflected on the bank's books, that the note will not be called for payment. The particular agreement in *Greaney* directly violated federal law and thus plainly was unenforceable. *See* 309 U.S. at 198. The agreement in *D'Oench, Duhme* apparently was not itself illegal, but it nonetheless was contrary to "the federal policy evidenced in [the Federal Reserve] Act to protect [the FDIC] from . . . misstatements as to the genuineness or integrity of securities in the portfolios of banks which it insures or to which it makes loans." 315 U.S. at 459. The Court therefore concluded:

> [T]he reach of the rule which prevents an accommodation maker of a note from setting up the defense of no consideration against a bank or its receiver or creditors is not delimited to those instances where he has committed a statutory offense. . . [A]n accommodation maker is not allowed that defense as against the receiver of the bank and its creditors, or at times even as against the bank itself, where his act contravenes a general policy to protect the institution of banking from such secret agreements.

Id. at 458. The rule applied in *D'Oench, Duhme* and *Greaney* is narrow both in its scope and in its rationale. Neither that rule nor any logical extension thereof sanc-

tions disregard of state statutes of limitations. Indeed, the rule of *D'Oench, Duhme* simply has nothing whatever to do with the prosecution of professional malpractice tort claims of the sort asserted by the FDIC in both *O'Melveny* and *Shrader & York*. *See, e.g., Astrup v. Midwest Federal Sav. Bank,* 886 F.2d 1057, 1059 (8th Cir. 1989); *FDIC v. Braemoor Assocs.,* 686 F.2d 550, 554 (7th Cir. 1982), *cert. denied,* 461 U.S. 927 (1983).

It is apparent, moreover, that the Ninth Circuit in *O'Melveny* erred in extrapolating from *D'Oench, Duhme* to a broad rule of federal common law that "equitable defenses good against the bank should not be available against the receiver." *O'Melveny* Pet. App. 15a. The court was mistaken in at least two respects. In the first place, *D'Oench, Duhme* does not contemplate two different substantive rules of law, depending upon the identity of the noteholder. To the contrary, the Court articulated a rule of universal applicability, which protects "a bank *or* its receiver *or* creditors" against enforcement of improper secret agreements. 315 U.S. at 458 (emphasis added). The Court was not overruling the long-standing rule that "the receiver stands no better than the bank." *Rankin v. City Nat'l Bank*, 208 U.S. 541, 546 (1908).

Secondly, the Court clearly did not intend to supplant state law root and branch in all cases brought by or against the FDIC. The rule enforced in *D'Oench, Duhme* and *Greaney* was itself firmly and explicitly rooted in "the policy of the National Banking Act." *D'Oench, Duhme,* 315 U.S. at 458. Absent the overriding authority of such a federal regulatory enactment, settled principles of state commercial and tort law provide a surer and fairer guide to the parties' respective rights and liabilities than does the Ninth Circuit's vague and general prescription that "equity does equity." *O'Melveny* Pet. App. 14a. If indeed federal common law has a role to play in this context, "[t]he presumption that state law should be incorporated into federal common law is particularly strong in areas in which private parties have entered

legal relationships [as in this case] with the expectation that their rights and obligations would be governed by state-law standards." *Kamen v. Kemper Financial Services, Inc.,* 111 S. Ct. 1711, 1717 (1991). The Ninth Circuit therefore erred in refusing to follow "well-established California law," *O'Melveny* Pet. App. 13a, and in "fashioning a federal rule of decision," *id.* at 14a, based upon nothing more than its own general notions of equity.

CONCLUSION

The judgment of the Ninth Circuit should be reversed.

Respectfully submitted,

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(8)

No. 93-489

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

O'MELVENY & MYERS,
A LAW PARTNERSHIP,
Petitioner,
v.

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS PARK II, and AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF *AMICI CURIAE* OF ARTHUR ANDERSEN & CO., COOPERS & LYBRAND, DELOITTE & TOUCHE, ERNST & YOUNG, KPMG PEAT MARWICK, AND PRICE WATERHOUSE IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

1. Whether the court of appeals erred by failing to incorporate state law as the federal rule of decision in determining whether the FDIC as receiver for a failed financial institution is entitled to recover under a cause of action for professional negligence that would have been defective if brought by the institution itself prior to receivership.

2. Whether the court of appeals erred by failing to incorporate state law as the federal rule of decision in determining whether the knowledge of a corporation's 100% shareholders and management should be attributed to the corporate entity.

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INTEREST OF THE AMICI CURIAE

With the consent of the parties pursuant to Rule 37 of the Rules of this Court, *amici curiae* submit this brief in support of petitioner O'Melveny & Myers ("O'Melveny"). *Amici curiae* are major professional service firms engaged in the practice of accounting and auditing. They are the six largest firms practicing this profession in the

United States, reporting, collectively, on the financial statements of more than 90% of those companies whose securities are publicly traded in the United States. Of particular relevance to this case, *amici curiae* serve as independent auditors for approximately 80% of the depository institutions or their parent corporations that are publicly traded in the United States. *See Who Audits America* 1-427 (Spencer Phelps Harris ed., 28th ed. 1992). Consequently, *amici curiae* are directly affected by the legal rights and obligations applicable to professionals who provide services to depository institutions and have a vital interest in the sound development of the law in this area.

The decision below greatly expands the powers of federal banking agencies when they act as receiver of a failed depository institution and as successor in interest assert negligence claims against the institution's outside professionals. Until the Ninth Circuit's decision, such claims generally have been governed by state law, which permits a variety of defenses based on the knowledge and conduct of a corporate client's officers, directors, and shareholders. The court of appeals, however, created two federal rules of decision, each of which grants the FDIC what is essentially a blanket exemption from such defenses. The court of appeals thereby created professional negligence liability under federal common law where none would have existed under state law.

The extent of an outside professional's liability for negligence is an issue that has been raised repeatedly in cases arising out of the savings and loan crisis of the 1980's. The issue is important not just for disposing of cases relating to depository institutions that already have failed, but also for the future. It is impossible to erect a wall between a professional's pre-receivership relationship with its client and the professional's post-receivership liability arising out of that relationship. Judicial expansion of a professional's exposure to post-insolvency negli-

gence liability not only will affect the cost at which professional services can be provided to ongoing institutions, but also the nature of such services and the manner in which they are provided.

Balancing competing policy considerations is peculiarly a legislative function. In 1989, after considering the views of both the banking agencies and the various professions, including the accounting profession, Congress provided regulators with a new administrative remedy against outside professionals that was designed to preserve the regulatory objectives of federal banking law. Yet this statutory remedy imposes liability only for serious misconduct and not for the mere negligence alleged in this case. *See* page 9, *infra*. The decision below, if allowed to stand, will upset this recent congressional policy determination and will impair the ability of *amici curiae* to provide quality and cost-effective services to their many depository institution clients.

STATEMENT OF THE CASE

The FDIC brought this action as receiver of American Diversified Savings Bank ("ADSB"), a failed savings and loan association, and, therefore, as a "former client[]" of O'Melveny. FDIC Opening Brief in C.A. No. 90-55769 at 1. The FDIC sought to recover from O'Melveny for failing to exercise due care in preparing offering memoranda for two real estate limited partnership offerings sponsored by ADSB affiliates. In particular, the FDIC alleged that O'Melveny negligently failed to discover and disclose that ADSB was in poor financial condition. O'Melveny responded by arguing that the officers who dominated and controlled ADSB's affairs and owned 100% of its stock, Ranbir Sahni and Lester Day, were well aware of and had deliberately concealed ADSB's true financial condition. Accordingly, O'Melveny contended that it could not be liable to its client for failing to discover and disclose that which the client already knew and

was concealing. The district court granted summary judgment to O'Melveny, but the court of appeals reversed. It held that O'Melveny owed ADSB a duty to investigate the truthfulness of the representations of ADSB's senior management, that the knowledge of Sahni and Day should not be imputed to ADSB, and that the FDIC as receiver was not subject to defenses based on the knowledge of Sahni and Day, even if those defenses would have been good against ADSB prior to receivership. Pet. App. 6a-15a.

SUMMARY OF ARGUMENT

It appears to have become "conventional wisdom" that outside professionals should be held substantially responsible for losses resulting from the extraordinary number of savings and loan associations that failed during the 1980's. *Amici curiae* submit, however, that the proper function of the federal judiciary is to ignore the untested generalities of "conventional wisdom" and instead to dispose of individual cases through disciplined application of established legal principles. If professionals are found liable in these circumstances, so be it.

It is entirely another matter when, as in this case, professionals would have no liability under settled principles of state law, yet federal courts simply discard these principles, create federal rules of decision, and impose liability based solely on their ad hoc policy views. It is particularly disturbing when the only policy identified is increasing the "asset pool" available to the federal banking agencies. Pet. App. 15a. Liability thus becomes an end in itself rather than the result of a neutral, judicial process. In these circumstances, the untested "conventional wisdom" that professionals are responsible for losses to the deposit insurance system is turned into a self-fulfilling prophecy simply by the tour de force of changing the rules after the game is over.

The decision below raises a fundamental issue of federal jurisprudence—whether the judiciary is free to fashion federal rules of decision favoring the federal banking agencies when they assert what otherwise would be traditional state law causes of action as receivers of failed depository institutions. The court of appeals answered this question affirmatively and created two federal rules of decision. The effect of each of these rules was to preclude O'Melveny from asserting a defense based on the knowledge of its client's officers, directors, and 100% shareholders, even though the defense would have required dismissal of the action under state law.

Whatever may be the merits of the Ninth Circuit's concern for the FDIC's asset pool, it surely is not the judiciary's function to give this policy the force of law in the absence of any direction from Congress. Indeed, the decision below is perhaps most striking for the court's failure even to attempt to identify statutory support for its policy views. In case after case arising out of financial institution failures, the FDIC and other banking agencies have requested courts to discard established state law legal principles in favor of federal rules based on the agencies' view of federal policy. The Court should affirm that the federal judiciary's function in such litigation is not to legislate new causes of action, but to apply established legal principles in an objective and disciplined manner. The judgment of the court of appeals should be reversed.

ARGUMENT

I. THERE IS NO NEED FOR THE FEDERAL COURTS TO FASHION A UNIFORM FEDERAL RULE GOVERNING WHETHER THE FDIC, ACTING AS RECEIVER FOR A FAILED DEPOSITORY INSTITUTION, IS SUBJECT TO DEFENSES BASED ON THE KNOWLEDGE OF THE INSTITUTION'S OWNERS AND MANAGEMENT

The entire opinion of the court of appeals was informed by its policy view that the FDIC should not be disadvantaged by the actions of those who owned and controlled the institution it represents as a receiver. *See, e.g.*, Pet. App. 10a (rejecting O'Melveny's defense "particularly in view of the public expectation that the wrongdoing [of corporate insiders] will be exposed, the wrongdoers pursued, and the innocent victims of fraud will have a chance at recovering"). Moreover, the court believed it was free to reject state law and fashion federal common law to effectuate this policy view. Pet. App. 13a-14a ("It is by now clear beyond doubt that federal, not state, law governs the application of defenses against FDIC. While we may incorporate state law to provide the federal rule of decision, we are not bound to do so.") (footnote omitted).

The court of appeals was mistaken. For the reasons fully discussed in the Brief For Petitioner, the statutory scheme enacted by Congress defining the rights of the FDIC as receiver leaves no room for the federal courts to create federal rules of decision expanding those rights. Moreover, even when a federal rule of decision is required, federal courts should incorporate state law as the federal rule of decision except when the federal "scheme in question evidences a distinct need for nationwide legal standards," "express provisions in analogous statutory schemes embody congressional policy choices readily applicable to the matter at hand," or application of state law "would frustrate specific objectives of the federal

programs." *Kamen v. Kemper Financial Services, Inc.*, 111 S. Ct. 1711, 1717 (1991) (citations and quotation marks omitted). None of these exceptions is applicable in this case.

A. Congress Itself Has Rejected Uniformity By Incorporating State Law In Statutes Specifying The Rights Of The FDIC As Receiver

Beginning with enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 ("FIRREA") (codified in scattered sections of Title 12), Congress has comprehensively addressed the issue of how to reform the federal regulatory scheme applicable to failed financial institutions and, where Congress considered it appropriate, has modified state law principles. For example, Congress has specifically overridden state law in certain limited respects by not requiring the FDIC to prove any more than gross negligence in receivership actions against officers and directors, 12 U.S.C. § 1821(k), and by imposing minimum limitations periods. 12 U.S.C. § 1821(d)(14).

Congress has not, however, expressed dissatisfaction with the principle that state law generally should provide the rule of decision on most issues. Indeed, even when Congress has found it appropriate to modify state law in some respect, Congress also has expressed its willingness otherwise to defer to state law. For example, FIRREA provides that directors and officers of insured depository institutions may be liable for gross negligence and intentional tortious conduct, "*as such terms are defined and determined under applicable State law.*" 12 U.S.C. § 1821(k) (emphasis added). Ironically, the Ninth Circuit itself has recognized the absence of a need for uniformity in a decision issued only three months after the decision below. In rejecting an argument that Section 1821(k) established a uniform standard of liability for officers of depository institutions, the court noted that "[*n*]*owhere does FIRREA indicate an aim to create na-*

tional uniformity in liability standards." *FDIC v. McSweeney*, 976 F.2d 532, 539 (9th Cir. 1992), *cert. denied*, 113 S. Ct. 2440 (1993) (emphasis added). In sum, the actions of Congress belie any argument that uniformity is required in actions brought by the FDIC as receiver for a failed depository institution.

B. Incorporation Of State Law Defenses To A Professional Negligence Cause Of Action Is Consistent With Federal Regulatory Policy

Perhaps the most significant flaw in the Ninth Circuit's legal analysis was its misapprehension of the nature of the allegations against O'Melveny. The court apparently believed, albeit mistakenly, that O'Melveny somehow participated in the wrongdoing of the ADSB insiders. *See, e.g.*, Pet. App. 6a ("O'Melveny contends . . . that the [FDIC] is subject to all defenses that might lie as between the wrongdoers themselves and those who may have aided and abetted them in bringing about the disaster."). The FDIC has never alleged, however, that O'Melveny colluded with the ADSB insiders in defrauding ADSB. To the contrary, the primary charge against O'Melveny is that it acted negligently (*i.e.*, in good faith but without due care) by *failing to discover* the wrongdoing of ADSB's owners and management. Because it missed this critical distinction, the court of appeals mistakenly believed that incorporating state law would conflict with federal regulatory policy.

1. Congress Has Determined That Federal Regulatory Objectives Are Preserved If Outside Professionals Are Held Responsible For Serious Misconduct As Opposed To Mere Negligence

In FIRREA, Congress addressed the issue of what additional powers were needed by the federal banking agencies to regulate the conduct of outside professionals who provide services to insured depository institutions, no doubt in response to many of the same policy consid-

erations that motivated the court of appeals in this case. Although Congress authorized the banking agencies acting in their governmental (as opposed to receivership) capacity to assert an administrative remedy against outside professionals, it imposed liability only for knowing or reckless behavior, not for mere negligence, and thus the government could not have maintained an action against O'Melveny for negligence if it had brought suit in its governmental capacity. *See* 12 U.S.C. § 1813(u) (definition of "institution-affiliated party" encompasses an "independent contractor (including any attorney, appraiser, or accountant)" only if the independent contractor "knowingly or recklessly participates" in any violation of law, breach of fiduciary duty, or unsound practice); 12 U.S.C. § 1818(b)(6)(A) (granting banking agencies the authority to require an "institution-affiliated party" to make restitution or reimbursement against loss in connection with issuance of a cease and desist order). In making this determination, Congress was aware of the complex policy considerations involved and acted only after hearing the views of all parties (H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 466, *reprinted in* 1989 U.S.C.C.A.N. 86, 262):

> *Balancing legitimate concerns with enforcement needs.* [FIRREA] places limitations on the banking agencies, so that they cannot utilize their enforcement authority over independent contractors for necessarily the same misconduct, abuse, or violations which can give rise to enforcement orders against officers, directors, and employees of financial institutions. Appraisers, accountants, and attorneys have participated in some of the serious misconduct in banks and thrift institutions and are defendants in numerous lawsuits brought by the FDIC and the FSLIC. However, the inclusion of these independent contractors has raised the concern of the American Institute of Certified Public Accountants, the American Bar Association's Business Law Section, and other groups. The Committee believes that section

> 901 addresses those concerns. Accordingly, the Committee has limited the exposure of independent contractors to serious misconduct.

This policy determination of Congress will be overturned if the decision below is allowed to stand. The court of appeals, concerned only with protecting the FDIC's "asset pool," would allow the FDIC to recover in this case even though (1) the government could not recover under the administrative remedy specifically created by Congress to protect the deposit insurance system, and (2) the failed institution itself or its successor-in-interest could not have recovered under established principles of state law. Whatever one thinks of the merits of the Ninth Circuit's views of federal policy, the judiciary clearly is not the proper forum for these decisions to be made. *See Bush v. Lucas,* 462 U.S. 367, 388, 390 (1983) (in deciding whether "an elaborate remedial system that has been constructed step by step, with careful attention to conflicting policy considerations, should be augmented by the creation of a new federal remedy," the Court declined to " 'create a new substantive legal liability without legislative aid' " because "Congress is in a better position to decide whether or not the public interest would be served by creating it").

2. *State Law Does Not Shield Outside Professionals From Liability If They Collude With Insiders In Defrauding An Institution*

It is important to recognize that if the FDIC had been able to allege (which it could not) that O'Melveny colluded with Sahni and Day in defrauding ADSB, their knowledge clearly could not have been imputed to ADSB. Under long-established state law principles, the knowledge of an agent will not be imputed to a principal, corporate or otherwise, if the agent and the third party are acting in collusion to defraud the principal. *See First Nat'l Bank v. Reed,* 244 P. 368, 371 (Cal. 1926) ("there is an exception to the general rule

imputing to the principal the knowledge of the agent, which exception is to the effect that, if the agent and the third party are acting in collusion to defraud the principal, the principal will not be held bound by the knowledge of the agent"); 3 William M. Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* § 804, at 54 (perm. ed. rev. vol. 1986) ("The rule imputing agents' knowledge to the principal is intended to protect those exercising good faith and not as a shield for unfair dealing.") (internal quotation marks omitted).

Thus, state law would have provided the FDIC, as receiver for ADSB, with a remedy for serious misconduct by an outside adviser that defrauded ADSB. In this respect, the state law rule is quite consistent with the statutory remedy enacted by Congress. The FDIC, however, could not allege this type of serious misconduct and therefore found it necessary to press the court of appeals to create federal common law in order to prevail. Because the court of appeals acceded to the FDIC's request rather than incorporating state law principles that were entirely consistent with federal regulatory policy, the judgment below must be reversed.

II. THE COURT OF APPEALS ERRED IN FASHIONING TWO FEDERAL RULES OF DECISION TO DEFEAT O'MELVENY'S STATE LAW DEFENSE

The court of appeals offered two rationales for its decision to reject O'Melveny's state law defense. Each of the rationales was based on a newly-created federal rule of decision that permitted the FDIC to assert ADSB's professional negligence cause of action against O'Melveny free of any state law defenses based on the conduct of ADSB's 100% owners and management. One rule achieved this result directly—the court of appeals simply held that it would be inequitable to allow such a defense to be asserted against the FDIC, regardless of whether the defense could have been asserted against ADSB prior

to receivership. Pet. App. 13a-15a. The second federal rule was more subtle and seemingly couched in terms of state law principles, but just as radical as the first rule in its actual departure from state law. The court adopted the FDIC's position that the knowledge of an agent of an insured depository institution cannot be imputed to the institution if the agent acted adversely to the interests of corporate outsiders, including particularly the federal government as deposit insurer. Id. at 10a-13a. The interests of outsiders thereby replaced the interests of shareholders, which would have been determinative under state law. As discussed next, the court of appeals erred by adopting these federal rules rather than incorporating state law.

A. In The Absence Of Statutory Authorization, The FDIC As Receiver Is Not Entitled To Recover On An Institution's Claim For Professional Negligence That Would Have Been Defective If Brought By The Institution Itself Prior To Receivership

Little need be said to demonstrate that the court of appeals impermissibly adopted a federal rule of decision in holding that the FDIC takes rights greater than those of the institution it represents as receiver. The court of appeals acknowledged that under California law a " 'receiver occupies no better position than that which was occupied by the . . . party for whom he acts . . . and any defense good against the original party is good against the receiver.' " Pet. App. 13a (alteration in original) (quoting *Allen v. Ramsay*, 179 Cal. App. 2d 843, 854 (1960)). Nevertheless, the Ninth Circuit rejected California law and fashioned its own federal rule of decision. *See* Pet. App. 13a ("The flaw in [O'Melveny's] argument is the law O'Melveny assumes applies. It is by now clear beyond doubt that federal, not state, law governs the application of defenses against FDIC."). Without attempting to ascertain congressional intent and guided only by "the age-old principle[] that equity does equity,"

the court concluded that "equitable defenses good against a bank do not carry over against the bank's receiver." *Id.* at 14a.

The Ninth Circuit believed the "intricate" federal statutory scheme for banking regulation would be frustrated if the FDIC were subject to defenses based on the wrongful conduct of the institution's owners and managers. *See, e.g.*, Pet. App. 6a ("O'Melveny contends that the federal agency created by Congress to rescue the economy and the victims of failing thrifts can claim no stronger ethical position than did the wrongdoers within that corporate entity . . . . We find such a proposition incredible . . . ."). Despite the Ninth Circuit's disbelief, the principle that a depository institution's receiver stands in the shoes of the institution is not new, but rather is an established principle of general receivership law. *See, e.g.*, *Coit Independence Joint Venture v. FSLIC*, 489 U.S. 561, 571 (1989) ("Once FSLIC is appointed receiver of an insolvent savings and loan association, FSLIC steps into the shoes of the association and takes control of its assets."); 2 Ralph E. Clark, *A Treatise on the Law and Practice of Receivers* § 362, at 619-620 (3d ed. 1959) ("The Supreme Court of the United States and federal authorities hold that the receiver of a bank stands in no better position than the bank stood as a going concern and when the bank was a party to an illegality, the court will leave the parties where it finds them by refusing relief to the receiver of such a bank.").

More importantly, Congress has not chosen to grant the FDIC the expanded powers that the Ninth Circuit provided by judicial fiat. Despite its general overhaul of the federal banking regulatory scheme with FIRREA, Congress has not expressed dissatisfaction with the general principle that the FDIC as receiver stands in the shoes of the institution. Indeed, the relevant federal statute does not enhance the FDIC's rights as receiver over those of the institution it represents, but provides that the

FDIC "shall, as conservator or receiver, and by operation of law, succeed to . . . all rights, titles, powers, and privileges of the insured depository institution . . . ." 12 U.S.C. § 1821(d)(2)(A)(i). The legislative history of FIRREA notes that established rules of receivership law generally continue to apply in FDIC litigation. *See* H.R. Rep. No. 54(I) at 330, *reprinted in* 1989 U.S.C.C.A.N. at 126 ("[FIRREA] defines the FDIC's authorities and duties as conservator or receiver. The authorities essentially parallel those heretofore exercised by the FSLIC and the FDIC . . . .").

It appears to have become the FDIC's standard litigation strategy to assert that state law principles should be disregarded because of an alleged federal "policy" of increasing the asset pool available to the federal government. Most courts have rebuffed the FDIC's efforts and instead have referred the agency to Congress. *See, e.g., FDIC v. Bowles Livestock Comm'n Co.*, 937 F.2d 1350, 1356 (8th Cir. 1991) ("Reduced to its essence this case asks only whether the FDIC may trump the ordinary operation of state laws. Precedent from this court cannot be as easily put aside as the FDIC would like, and instead mandates that the laws of Nebraska supply the substance of federal law."); *Sunbelt Sav., FSB Dallas, Tex. v. Montross*, 923 F.2d 353, 357 (5th Cir.) ("When the FDIC assumes control of an institution, the assets are what they are. . . . We agree that the FDIC should not be disadvantaged by the circumstances of its assumption of control, *but this policy does not require giving the FDIC the ability to transmute lead into gold. . . . Alchemy is the province of Congress* . . . .") (emphasis added), *reinstated on reh'g en banc*, 944 F.2d 227 (5th Cir. 1991) (per curiam).[1] The court of appeals' failure

[1] *See also FDIC v. Ferguson*, 982 F.2d 404, 407-408 (10th Cir. 1991) ("The FDIC's stepping in [to a lawsuit filed by a failed institution] after nearly three years of litigation, asserting the taxpayers' loss as guarantor of insured deposits, does not transfer the case into the realm of the public interest."); *FDIC v. Jenkins*, 888 F.2d 1537, 1544 (11th Cir. 1989) (the Supreme Court's "deference [in *Langley v. FDIC*, 484 U.S. 86 (1987)] to the legislation enacted by Congress . . . should serve as a guide for this Court in denying the FDIC's effort to create a priority which appears nowhere on the face of the Federal Deposit Insurance Act"); *FDIC v. Braemoor Assocs.*, 686 F.2d 550, 554 (7th Cir. 1982) ("The FDIC is suing as the assignee of the State Bank of Clearing's cause of action under state law against the defendants, and it is difficult to see why assignment to the FDIC should alter or enlarge that cause of action."), *cert. denied*, 461 U.S. 927 (1983).

in this case to resist the temptation to effectuate its own policy preferences by creating federal common law requires reversal of the judgment below.

B. The Court Of Appeals Erred By Rejecting The State Law Rule That The Knowledge Of A Corporation's 100% Owners And Management Is Imputed To The Corporate Entity

The court of appeals began its analysis of whether the knowledge of Sahni and Day should be imputed to ADSB by reciting two unexceptional and undisputed principles of corporate law: (1) a corporation is a distinct legal entity separate from its stockholders and from its officers; and (2) the knowledge of a corporate officer acting within the scope of his or her employment is attributed to the corporation unless the officer was acting adversely to the corporation. Pet. App. 10a-11a.[2] The first prin-

[2] The court of appeals chose to address the issue whether Sahni and Day's knowledge should be imputed to ADSB solely in the context of whether O'Melveny could assert the equitable defense of estoppel. Imputation also is a general principle of corporate law that can affect many of the elements of a professional negligence cause of action, including reliance, causation, compliance with a statute of limitations, and contributory negligence. *See, e.g.*, 3 Fletcher § 815, at 99 ("These general rules [of imputation] apply, of course, in a great variety of cases—in fact, in any case in which the question whether a corporation had notice of a particular fact is material. Thus, they apply when it is sought to charge the corporation with an officer's knowledge that a particular transaction was in fraud of third persons, . . . or to charge a corporation with notice of its own insolvency . . . .") (footnotes omitted).

ciple is irrelevant in this case because imputing the knowledge of an agent to the corporate entity does not require "piercing the corporate veil" or proof that the agent was the "alter ego" of the corporate entity. Rather, the general rule, even accepting the separate existence of the corporate entity, is that an agent's knowledge will be imputed to the corporate entity because it is a legal fiction that can know and act only through its individual agents. *See* 3 Fletcher §787, at 12 ("[A] corporate body, as a legal entity, cannot itself have knowledge. If it can be said to have knowledge at all, that must be the imputed knowledge of some corporate agent. Knowledge of the proper corporate agent must be regarded, in legal effect, as the knowledge of the corporation.").

It was in applying the "adverse interest" exception to the general imputation rule that the court of appeals departed from state law and created a federal rule of decision. The court of appeals held that Sahni and Day had acted adversely to ADSB—the corporate entity that they totally owned and controlled. This holding is directly contrary to the straightforward state law rule that there can be no adverse interest between a corporation and its 100% owners and management.[3] As a preeminent authority on corporate law has explained, "[w]here the officer to whom notice is given or by whom knowledge is acquired is in effect the corporation, the notice is generally imputed to the corporation. . . . So, *the rule that a corporation is not charged with the knowledge of an officer acting adversely to it does not apply where an officer is also the sole stockholder* . . . ." 3 Fletcher § 809, at 76-77 (emphasis added) (footnotes omitted). Indeed, the rules of imputation were developed in order to pre-

[3] As fully discussed in the Brief For Petitioner, the court of appeals' holding also is contrary to the state law rule that the knowledge of an agent will be imputed when "the agent is in fact acting for his principal in the transaction, even though he may have an opposing personal interest." *McKenney v. Ellsworth*, 132 P. 75, 76 (Cal. 1913).

clude a corporation from claiming it did not have notice *because* "the facts were not communicated to the shareholders as a body or to the board of directors." *Id.* at § 786, at 11.[4]

To reach a result contrary to this state law rule, the court of appeals necessarily ignored the interests of ADSB's shareholders. Instead, it is apparent that the court adopted the FDIC's position that the interests of corporate outsiders, in particular the federal government as deposit insurer, should be determinative of the issue whether an agent of an insured depository institution has acted adversely to the institution. This subtle, though dispositive, shift in analysis represents a federal rule of decision that is directly contrary to California law governing the scope of a professional's liability for negligence.

1. *By Adopting The FDIC's "Federal Interest" Approach, The Court Of Appeals Fashioned A Novel Federal Rule Of Decision*

In its brief to the court of appeals, the FDIC proposed a radical change from state law principles in determining

[4] *See also J.J. McCaskill Co. v. United States*, 216 U.S. 504, 515 (1910) (refusing to apply adverse interest exception to corporate officers who "own[ed] a large majority of the stock of said corporation, with the entire management and control of the business and affairs," because the "interest of the corporators and the corporation [was] thus shown to be identical, not adverse"); *McKee v. American Casualty Co.*, 316 F.2d 428, 430 (5th Cir. 1963) ("The fact that [a sole shareholder] t[akes] the corporation's money does not insulate it from the knowledge he possese[s] since there [i]s no adverse interest between [the shareholder] and the corporation wholly owned by him."); 3 Maurice H. Merrill, *Merrill On Notice* § 1273, at 257 (1952) (footnotes omitted) ("[T]he adverse interest rule does not apply to the case where the hostilely concerned officer of a corporation is himself, through ownership or control, substantially the corporation. In such a case, however much the technical interests of the corporation viewed as a legal entity may be opposed to those of the agent, the fact remains that there is substantial identity between them and that the institution is only his pawn.").

the "interests" of an insured depository institution. In particular, the FDIC argued that the interests of the federal government, as deposit insurer, should take precedence over those of the institution's owners in determining whether the knowledge of its agents should be attributed to the institution:

> As a separate legal entity, ADSB has rights and liabilities different from those of its shareholders, directors and officers. *Certainly a federally insured thrift institution cannot be identified simply with its shareholders*, in view of the far more substantial economic investment in the institution made by the institution's depositors, as well as the substantial public interest in the thrift arising from the federal government's "full faith and credit" backing of the bank's deposits.

FDIC Opening Brief in C.A. No. 90-55769 at 27-28 (emphasis added) (footnote omitted).[5]

Having apparently accepted the FDIC's argument that the interests of the federal government in ADSB should be elevated over those of its owners, the court of appeals cited two federal cases holding that "conduct aggravating a corporation's insolvency and fraudulently prolonging its life does not benefit the corporation." Pet. App. 12a (citing *Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983), and *In re Investors*

[5] The only authority cited by the FDIC in support of this "federal interest" analysis was *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901 (D.D.C. 1990). That decision, which did not deal with imputation of knowledge, but rather with whether federal regulators acted properly in placing an S&L into conservatorship, contains the following statement: "While plaintiff ACC [the S&L's parent corporation] invested some $51 million to purchase Lincoln, the institution's $1 billion in assets came from depositors with federally insured accounts. Thus, by virtue of its insurance of Lincoln accounts, the federal government's interest in Lincoln is many times that of ACC." 743 F. Supp. at 905. The court of appeals cited *Lincoln* as supporting its refusal to impute Sahni and Day's knowledge to ADSB. Pet. App. 12a.

Funding Corp., 523 F. Supp. 533 (S.D.N.Y. 1980)).[6] This "deepening insolvency" theory makes sense, however, only if one considers the interests of the corporation to be those of corporate outsiders rather than those of shareholders. Prolonging the life of a corporate entity, even if it results in greater insolvency (*i.e.*, more unpaid debt to outside creditors) may well serve to benefit the shareholders. Although a corporation may be in very weak financial condition, its owners and management still may have hopes of turning the corporation around and avoiding bankruptcy. Whether or not such hopes are realistic, prolonging the corporation's life is intended to benefit the corporation's shareholders. If the efforts do not succeed and bankruptcy follows, it likely will be creditors and other outsiders who will bear the lion's share of the cost.

The court of appeals' departure from state law is graphically demonstrated by the direct conflict between its decision and the Fifth Circuit's decision in *FDIC v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992). The Ninth and Fifth Circuits each purported to apply the adverse interest exception to nearly identical facts, yet reached opposite conclusions. The courts' conflicting holdings are explained entirely by the law they chose to apply.

In *Ernst & Young*, the Fifth Circuit affirmed the grant of summary judgment to an outside auditor who had asserted a defense based on the knowledge of the 100% owner and controlling manager of its client—like ADSB, a failed depository institution. In reaching its decision, the court applied Texas law, holding that the corporation's interests were those of its shareholders at the time of the officer's actions, not the interests of outsiders such as creditors and depositors. *See Ernst & Young*, 967

[6] It is noteworthy that *Investors Funding* did not cite any authority, state or federal, in support of its "deepening insolvency" theory, and *Schacht* cites only *Investors Funding* in support of the theory.

F.2d at 171 ("Fraud on behalf of a corporation is not the same thing as fraud against it. Fraud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims . . . . But the primary costs of a fraud on the corporation's behalf are borne not by the stockholders but by ousiders to the corporation . . . .") (citations and internal quotation marks omitted). Given this legal standard, the Fifth Circuit had no trouble deciding that a 100% shareholder could not act adversely to the corporation he owned and controlled. *See* 967 F.2d at 171 ("Woods acted on the corporation's behalf because by serving Western [the failed S&L], he served himself, Western's sole owner. As the sole owner, Woods' fraudulent activities on Western's behalf benefitted himself and injured outsiders to Western —i.e. depositors and creditors. Accordingly, under [Texas law], Woods acted on Western's behalf, and, therefore, his knowledge is imputable to Western.").

The Ninth Circuit, in contrast, was able to reach an opposite result only be creating a federal rule of decision in considering the interests of the federal government as deposit insurer to the exclusion of the interests of ADSB's shareholders. By doing so, the Ninth Circuit expanded a professional's liability to third parties for negligence far beyond the bounds permitted by state law.

2. *The Court Of Appeals' Federal Rule Of Decision Expands Professional Negligence Liability To Third Parties Beyond The Limits Set By State Law*

The court of appeals' decision represents an end-run around settled state law rules that are intended to maintain the negligence liability of a professional to third parties, including particularly creditors of a corporate client, within rational bounds. Of particular relevance in this case, the California Supreme Court has strictly limited the liability of a professional to such parties. First, only the client is permitted to assert a general negligence claim against the professional. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 767 (Cal. 1992) ("we hold that an auditor's liability for general negligence in the conduct of an audit of its client['s] financial statements is confined to the client i.e., the person who contracts for or engages the audit services").[7] Second, non-clients may bring a cause of action for the separate tort of negligent misrepresentation, but only if (1) they can prove justifiable reliance on the professional's representations, *id.* at 772 ("By allowing recovery for negligent misrepresentation (as opposed to mere negligence), we emphasize the indispensability of justifiable reliance on the statements contained in the report."), and (2) they belong to a particular class of persons and engaged in a specific type of transaction that the professional intended to influence when it made its representation. *Id.* at 772-773 (adopting "intent to benefit" approach set forth in Section 552 of the *Restatement (Second) of Torts*).[8]

The principal reason identified by the California Supreme Court for adopting the *Restatement* rule was to

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[7] *Bily* addressed professional negligence liability in the context of an accountant that issues an inaccurate audit report, but its holding encompasses all types of professionals. 834 P.2d at 770 ("Accountants are not unique in their position as suppliers of information and evaluations for the use and benefit of others. Other professionals, including attorneys, architects, engineers, title insurers and abstractors, and others also perform that function. And, like auditors, these professionals may also face suits by third parties claiming reliance on information and opinions generated in a professional capacity.").

[8] Section 552(2) of the *Restatement* provides that a professional's liability for negligent misrepresentation is limited to "loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction."

maintain rational limits on the scope of a professional's liability for mere negligence:

> The rule expressed there attempts to define a narrow and circumscribed class of persons to whom or for whom representations are made. *In this way, it recognizes commercial realities by avoiding both unlimited and uncertain liability for economic losses in cases of professional mistake* . . . . The Restatement rule thus appears to be a sensible and moderate approach to the potential consequences of imposing unlimited negligence liability which we have identified.

834 P.2d at 769 (emphasis added).[9]

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[9] The vast majority of states have adopted either the *Restatement's* limitations on a professional's liability for negligence or the "near-privity" approach, which is more restrictive of a non-client's standing to sue than the *Restatement* approach. *See, e.g., Colonial Bank of Alabama v. Ridley & Schweigert*, 551 So. 2d 390 (Ala. 1989) (near-privity); *First Florida Bank v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990) (*Restatement*); *Badische Corp. v. Caylor*, 356 S.E.2d 198 (Ga. 1987) (*Restatement*); *Idaho Bank & Trust Co. v. First Bancorp of Idaho*, 772 P.2d 720 (Idaho 1989) (near-privity); *Essex v. Ryan*, 446 N.E.2d 368 (Ind. Ct. App. 1983) (near-privity); *Pahre v. Auditor of the State of Iowa*, 422 N.W.2d 178 (Iowa 1988) (*Restatement*); *Lindner Fund v. Abney*, 770 S.W.2d 437 (Mo. Ct. App. 1989) (*Restatement*); *Citizens Nat'l Bank of Wisner v. Kennedy and Coe*, 441 N.W.2d 180 (Neb. 1989) (near-privity); *Credit Allliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985) (near-privity); *Spherex, Inc. v. Alexander Grant & Co.*, 451 A.2d 1308 (N.H. 1982) (*Restatement*); *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609, 616 (N.C. 1988) (*Restatement*); *BankOhio Nat'l Bank v. Schiesswohl*, 515 N.E.2d 997 (Ohio Ct. App. 1986) (*Restatement*); *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991) (*Restatement*); *Haberman v. Public Power Supply System*, 744 P.2d 1032 (Wash. 1987) (*Restatement*), *appeal dismissed*, 488 U.S. 805 (1988); *First Nat'l Bank of Bluefield v. Crawford*, 386 S.E.2d 310 (W. Va. 1989) (*Restatement*).

Contra Touche Ross v. Commercial Union Ins. Co., 514 So. 2d 315 (Miss. 1987) (liability to reasonably foreseeable third parties); *Rosenblum Inc. v. Adler*, 461 A.2d 138 (N.J. 1983) (same); *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361 (Wis. 1983) (same).

Thus, it is clear that the FDIC and other creditors of ADSB did not have standing in their own right to assert a claim for general negligence against O'Melveny. The FDIC was able to assert such a claim in this case only in its receivership capacity as ADSB's successor-in-interest. Yet the FDIC has sought to avoid state law defenses based on the interests of creditors and other corporate outsiders. Tellingly, the FDIC subsequently has attacked the Fifth Circuit's analysis in *Ernst & Young* by claiming that the court failed to appreciate the FDIC's statutory authority to represent stockholders and depositors of a failed institution, as well as the institution itself. *See, e.g., FDIC v. Shrader & York*, 991 F.2d 216, 223 (5th Cir. 1993) ("The FDIC attempts to distinguish *Ernst & Young*, arguing that, in this case, it is suing on behalf of depositors and other creditors, not just on behalf of the failed institutions."), *petition for cert. filed*, 62 U.S.L.W. 3336 (U.S. Oct. 26, 1993) (No. 93-651). The FDIC's argument is defective because it fails to recognize the critical distinction between (1) the party to whom a cause of action *belongs*, and (2) the parties who will *benefit* from the FDIC's successful assertion of the cause of action.

The federal government, as insurer of ADSB's deposits and hence one of ADSB's largest creditors, would no doubt benefit from a successful professional negligence claim against O'Melveny. The cause of action asserted by the FDIC, however, was not the depositors' or creditors' cause of action. Although the FDIC may have authority to represent a variety of parties and a variety of parties may benefit if the FDIC successfully asserts a claim for professional negligence, if it chooses to assert a cause of action belonging only to the institution itself, the FDIC must satisfy all of the elements of that cause

of action. Likewise, if the FDIC asserts a cause of action on behalf of an institution's creditors or depositors, it must satisfy all of the elements of that cause of action. The Fifth Circuit has recognized and rejected the FDIC's muddled legal analysis. *See Ernst & Young*, 967 F.2d at 171 ("Western cannot claim it should recover from EY for not being rescued by a third party for something that Western was already aware of and chose to ignore. Neither can Western's assignee make the claim. The FDIC in its own capacity or Western's creditors might be able to make this claim, but the FDIC brought this suit only on Western's behalf."); *Shrader & York*, 991 F.2d at 223 ("the FDIC has not pled or offered summary judgment evidence that . . . depositors and other creditors were clients of Shrader & York, and thus able to sue Shrader & York for professional malpractice" under Texas law).

In both this case and *Ernst & Young*, the FDIC chose to assert a cause of action belonging only to the failed institutions, not to the institutions' depositors or creditors. The Fifth Circuit respected state law and required the FDIC to satisfy all of the elements of the cause of action it brought. The Ninth Circuit, however, did not, and the federal rule it created would apply in a class of litigation that subjects professionals to the very type of crushing liability out of proportion to fault that state law precludes.

3. *Judicial Respect For State Law Limitations On Professional Negligence Liability Is Particularly Important In Litigation Arising Out Of The S&L Crisis Of The 1980's*

The FDIC and the Resolution Trust Corporation have launched the equivalent of a legal blitzkrieg against professionals who provided services to failed depository institutions. In 1990, the Chairman of the FDIC testified before Congress that the "FDIC and RTC currently are conducting investigations in 1,300 institutions and have filed more than 500 lawsuits against former directors,

officers, and other professionals for damages ranging from \$1 million to \$1 billion." *FDIC Considers Suits Against S&L, Bank Officials in 1,300 Institutions*, 55 Banking Rep. (BNA) 97 (July 16, 1990) (internal quotation marks omitted). To carry out this massive task, the FDIC has retained the services of hundreds of law firms and has paid astronomical amounts of legal fees. *See FDIC, RTC Set Fee Cap On Outside Counsel, Say \$615 Million Spent In 1990 Legal Fees*, 56 Banking Rep. (BNA) 314 (Feb. 18, 1991) ("The agency also said the figures include expenses for legal efforts against former executives and professionals—frequently lawyers and accountants—for which the FDIC paid outside counsel about \$80 million and received \$373 million.").

It is perhaps inevitable that this long and concerted effort has produced many lawsuits alleging negligence on the part of outside professionals. Moreover, the damages sought in these cases often are mind-boggling and can threaten the very livelihood of even the largest professional service firms, all because of alleged negligence in a single professional engagement. For example, in *Ernst & Young*, the FDIC sought to recover \$560 million in damages resulting from the failure of a single institution. 967 F.2d at 169. It has been reported that lawsuits pending in 1993 against accounting firms in connection with failed depository institutions allege a total of \$2.3 billion in damages. *Breeden Says Financial Fraud Bill Is A "Step In The Right Direction,"* 60 Banking Rep. (BNA) 262 (Mar. 1, 1993).

It is apparent that the FDIC and other banking agencies are seeking to use the deep pockets of outside professionals as a fund to recoup losses racked up by S&L's in the 1980's. This phenomenon of looking to professionals for a deep pocket from which to recover economic losses was well described by the California Supreme Court in *Bily*:

> The auditing CPA has no expertise in or control over the products or services of its clients or their markets; it does not choose the client's executives or make its business decisions; yet, when clients fail financially, the CPA auditor is a prime target in litigation claiming investor and creditor economic losses because it is the only available (and solvent) entity that had any direct contact with the client's business affairs.

834 P.2d at 763.

In many, if not most, of the lawsuits brought by the FDIC, the allegations are similar to those in this case—that outside professionals should have discovered and stopped practices of the institution's owners and managers about which, as in this case, the regulatory authorities had at least as much information as the professional, if not more. Under this type of theory, defenses based on the knowledge and conduct of the institution's owners and management often will be an important aspect of the professional's litigation strategy. Yet the federal rule created by the court of appeals would preclude such defenses and expose professionals to staggering liability based on the interests of third parties to the professional/client relationship.

Thus, the decision below directly implicates the concerns that led state courts to limit the standing of third parties to sue a corporation's outside professionals. One of the potential consequences identified in *Bily* of holding professionals liable to third parties for negligence was imposing liability entirely out of proportion to fault. The court described this problem in language that is peculiarly applicable to cases brought by the FDIC:

> [J]udicial endorsement of third party liability negligence suits against auditors limited only by the concept of foreseeability raises the spectre of multibillion-dollar professional liability that is distinctly out of proportion to: (1) the fault of the auditor (which is necessarily secondary and may be based on complex differences of professional opinion); and

> (2) the connection between the auditor's conduct and the third party's injury (which often will be attenuated by unrelated business factors that underlie investment and credit decisions).
>
> As other courts and commentators have noted, such disproportionate liability cannot fairly be justified on moral, ethical, or economic grounds. As one commentator has summarized: "The most persuasive basis for maintaining the limited duty [of auditors] is a proportionality argument. . . . It can be argued as a general proposition in these cases that the wrongdoing of an accountant is slight compared with that of the party who has deceived him (his client) as well as the plaintiff. This rationale for nonliability is similar to the proximate cause grounds on which willful intervening misconduct insulates a 'merely negligent' party from liability."

834 P.2d at 764 (citations omitted) (quoting Rabin, *Tort Recovery for Economic Loss: A Reassessment,* 37 Stan. L. Rev. 1513, 1536-1537 n.74 (1985)).

In sum, the state law limitations on a professional's liability to third parties for negligence were intended to apply and preclude liability disproportionate to fault in just the type of litigation as has arisen out of the S&L crisis. By rejecting O'Melveny's state law defense in order to further the interests of outsiders to the professional/corporate client relationship, the court of appeals adopted a federal rule that violated this fundamental state law determination. Making a policy decision with such far-reaching consequences is the province of Congress, not the federal courts.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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January 1994

(9)

No. 93-489

In The
Supreme Court of the United States
October Term, 1993

O'Melveny & Myers,
a Law Partnership,
Petitioner,
v.

Federal Deposit Insurance Corporation, as Receiver for American Diversified Savings Bank, ADC Financial Corporation, American Diversified/Wells Park II, and American Diversified/Gateway Center,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE AMERICAN BAR ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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IN THE
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O'MELVENY & MYERS,
A LAW PARTNERSHIP,
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v.

FEDERAL DEPOSIT INSURANCE CORPORATION, AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS PARK II, AND AMERICAN DIVERSIFIED/GATEWAY CENTER,
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BRIEF FOR THE AMERICAN BAR ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE AMICUS CURIAE

The American Bar Association ("ABA") is a voluntary membership organization of the legal profession dedicated to the promotion of a fair and effective system for the administration of justice and the uniformity of judicial decisions. *See* ABA Const., art. 1, § 1.2. Since 1908, with the adoption of the original *Canons of Professional Ethics,* the ABA has taken a leadership role in legal ethics and professional responsibility through the

adoption of professional standards intended to serve as models for the states' regulation of the legal profession. The most recently adopted set of standards, *The Model Rules of Professional Conduct,* together with its predecessor, *The Model Code of Professional Responsibility*, continues to serve as the principal framework by which the several states regulate the practice of law.

The issue presented in this case directly addresses the role that the legal profession plays in the administration of justice, as a counsellor of corporations, specifically financial institutions.[1] This case concerns the liability of legal counsel when the client commits a fraud, unknown to counsel, upon counsel and third parties, and the Federal Deposit Insurance Corporation ("FDIC"), as successor to the thrift institution, sues the law firm pursuant to state law for malpractice. Under the state law upon which the FDIC's cause of action was based, legal counsel would have had a defense to FDIC's claim. The FDIC argued that the defense should be ignored, in order to maximize recovery. In response, the Court of Appeals created a federal common law rule and applied it as the rule of decision, thereby negating the state law defense.

The ABA's reason for filing an *amicus curiae* brief in this case is to address two aspects of the Ninth Circuit opinion that would have substantial adverse implications for the practice of law. The Ninth Circuit, although relying on state law to provide the basis for a tort cause of action, ruled that the identity of the plaintiff, a federal agency successor to one corporate client, should cause the Ninth Circuit to "trump" state law by creating a federal common law rule that would negate the defendant's defense under California law. There have been a substantial number of suits instituted by the FDIC and the Resolution

[1] This brief *amicus curiae* is filed with the consent of the parties. Copies of their consent letters are on file with the Clerk of the Court.

Trust Corporation ("RTC") against lawyers who have represented savings and loan associations and commercial banks. The Ninth Circuit's ruling, if final, would have far-reaching consequences to such lawyers who believed that any malpractice responsibilities would be governed by state law.

The Ninth Circuit opinion also implies that a law firm has some sort of duty of investigation that is owed to non-client third parties. It would appear, under the reasoning of the Ninth Circuit, although the opinion is unclear on this point, that the recipient of this duty is the FDIC, or its predecessor, the Federal Savings and Loan Insurance Corporation ("FSLIC"). Such an alleged duty would come into existence only after a federal agency conservator or receiver is appointed and would retroactively change the relationship between lawyer and client.

The advice and services that legal counsel provide to their clients is governed at least partly by controlling state law, particularly when the client is chartered under state law. If, subsequent to the provision of these services, the client is thereafter placed in a federal agency conservatorship or receivership, and the otherwise applicable state law is replaced by newly created federal law, solely to maximize recovery by a federal agency receiver in a tort action against third-party professionals, the likely result would be to have a significant chilling effect on the zealous representation of clients and could even lead to those clients not being represented by legal counsel. If the potential presence of a federal agency as receiver in a case thereby could change controlling law, legal counsel would be required to provide dual or alternative and possibly even conflicting advice to corporate clients, while recognizing that the government takeover of the client could result in the removal of all defenses to a malpractice claim. This not merely could and would affect advice provided by lawyers, because of the inherent conflict of interest, but more likely would result in certain entities,

or entities in financial difficulty, not being represented at all.[2]

The ABA is therefore concerned about the threat this case presents to the system of state regulation of the bar—and to the attorney-client relationship itself—posed by selectively and retroactively imposed liability, stemming from courts, under the putative authority of federal common law. If the presence of FDIC as receiver in a suit can change the controlling law governing professional liability, counsel for financial institutions would be obliged to look over their own shoulders each time they are called upon to provide legal services. Even more constraining is the implication that legal counsel may owe a duty to constituents other than the client, constituents who, directly or indirectly, may have causes of action. This implied duty raises the specter of conflict of interest even in routine transactions. This impairs the ability of the financial institution bar to provide totally disinterested advice and to represent their clients zealously.[3]

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[2] This *amicus* brief is submitted to the Court, in part, because of the analysis by and the report of the ABA Working Group on Lawyers' Representation of Regulated Clients, *Laborers in Different Vineyards? The Banking Regulators and the Legal Profession* (Discussion Draft Jan. 1993) ("ABA Discussion Draft"). The recommendations of that report resulted in a resolution of the ABA House of Delegates adopted in February 1993. Although the report discussed primarily the administrative agencies and administrative actions instituted by them against lawyers and law firms, the report also discussed civil actions by federal agency receivers, and the duties of lawyers to investigate, including the circumstances of the instant case. The report recognized the dangers to the legal profession presented by the Ninth Circuit decision. *Id.* at 43-45, 124-31 and 186-87.

[3] Neither this brief nor the decision to file it should be interpreted to reflect the views of any judicial member of the American Bar Association. No inference should be drawn that any member of the Judicial Administration Division Council has participated in the adoption of or endorsement of the positions in this brief. This brief was not circulated to any member of the Judicial Administration Division Council prior to filing.

SUMMARY OF ARGUMENT

The Ninth Circuit did not apply—did not even cite—the leading U.S. Supreme Court cases such as *United States v. Kimbell Foods, Inc.*,[4] and *Kamen v. Kemper Fin. Serv., Inc.*,[5] and did not analyze the case in the context of the three-prong test laid out by this Court in 1979 in *Kimbell Foods*. None of the three criteria of *Kimbell Foods*, the third of which is the most relevant to the ABA, is satisfied in this case.

The third question involved in the *Kimbell Foods* test, that is, whether a federal rule of decision would disrupt commercial relationships predicated on state law, is of direct concern to the ABA because the relationship of lawyers to their clients, and the relationship of lawyers to their supervisory authority, relationships which have been in the past almost solely controlled by state law, would be disrupted by the Ninth Circuit's decision. Furthermore, as described in more detail in this brief, lawyers have assisted financial institutions to be on the cutting edge of change, in order for their financial institution clients to remain competitive. The Congress at times has been unwilling for political reasons to approve specifically such changes but has impliedly permitted them by failing to disapprove. If federal agencies which disagree with such initiatives also have the power at a later date to second guess legal advice through the invocation of federal common law, to negate defenses to malpractice actions otherwise controlled by state law, that power could inhibit zealous representation.

FDIC's contention in this and other cases, that a federal court should and can create federal common law whenever that would maximize or permit recovery in a tort claim, has no support in the Financial Institutions Reform,

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[4] 440 U.S. 715 (1979).

[5] 500 U.S. ——, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991).

Recovery and Enforcement Act of 1989 ("FIRREA"),[6] or in any other statute, nor does it have support in any case law of this Court. This Court has limited narrowly the power of federal courts to displace state law as the rule of decision and has created through case law a virtual presumption in favor of the application of state law, not merely in diversity cases.

When civil courts have created or followed federal law in FDIC receivership cases, they have done so in recognition of quite different issues. The instant case, involving attribution of conduct by stockholders/officers/directors to a plaintiff corporation in a tort claim, does not present such an issue. Nor, under the facts of this case, are the circumstances present (as they have been in the case of FDIC purchase and assumption transactions involving commercial banks) for the creation or imposition of federal common law as the rule of decision.

Normally, the receiver of a business corporation stands in the shoes of the corporation, thereby acquiring both its rights and its responsibilities. The FDIC contends that, while it succeeds to all such rights, it bears only those responsibilities that would not bar or limit recovery in tort damage actions. The FDIC has made this maximization argument in numerous cases involving claims against lawyers. The federal courts, in general, have not accepted this argument. This Court by its ruling should reject FDIC's claim that federal courts can and should override state law whenever the state law gets in the way of FDIC recovery.

The Ninth Circuit should have applied the law of California to this case.

[6] Pub. L. No. 101-73, 103 Stat. 183 (1989).

ARGUMENT

I. MAXIMIZING RECOVERY FOR THE FDIC IS NOT A PROPER BASIS IN LAW FOR DISPLACING PRE-EXISTING STATE LAW, AND ITS CORRESPONDING LAWYER/CLIENT RELATIONSHIPS, BY A NEWLY CREATED FEDERAL COMMON LAW

A. This Court Has Indicated That It Is Only Appropriate for Federal Courts to Create Federal Common Law When Three Specific Conditions Are Satisfied

This Court, in *United States v. Kimbell Foods, Inc.*,[7] articulated a three-prong test to be applied by a federal court, when determining whether federal common law should be applied in place of the relevant and otherwise applicable state law, as the court's rule of decision.

> [First,] federal programs that "by their nature are and must be uniform in character throughout the Nation" necessitate formulation of controlling federal rules. . . . Conversely, when there is little need for a nationally uniform body of law, state law may be incorporated as the federal rule of decision. [Second,] [a]part from considerations of uniformity, we must also determine whether application of state law would frustrate specific objectives of the federal programs. If so, we must fashion special rules solicitous of those federal interests. [Third,] [f]inally, our choice of law inquiry must consider the extent to which application of a federal rule would disrupt commercial relationships predicated on state law.[8]

None of those criteria is triggered in the instant case.

[7] 440 U.S. 715 (1979).

[8] 440 U.S. at 728-29.

1. *Application of a Federal Rule of Decision Would Disrupt Commercial Relationships Predicated on State Law*

Turning initially to the third criterion in the *Kimbell Foods* case, it would bar the applicability of federal common law in the instant case. The relationship in this case, in part a commercial relationship, was predicated on state law. O'Melveny & Myers' principal office was in California, and it supplied legal advice to the California subsidiaries of a California thrift. Presumably, that advice was based primarily on state law, and the firm could assume, in 1985, that its professional responsibilities were governed by the law of the State of California which controlled admission, practice, supervision and discipline of lawyers practicing in California.

In January 1991, when the FDIC filed its reply brief in the Ninth Circuit, O'Melveny & Myers was advised that the FDIC took the position that a 1985 relationship was governed by federal law or federal common law.[9] How could O'Melveny & Myers in 1985 have assumed that its advice to its clients would be controlled years later by federal law, triggered by the conservatorship or receivership of the parent thrift? How could it assume that its professional responsibilities to its clients would be governed by a new federal rule, created by a court in June 1992? The answer is that this turn of events could not have been expected, and should not have been expected.

[9] In the FDIC's briefs before the Ninth Circuit, only two footnotes in its Reply Brief contended that federal common law should be created by the Court. Footnotes 17 and 18, pp. 18-19 of Reply Brief. In both of its briefs, it couched the issue, comparable to the Question Presented in its Brief in Response to Petitioner's Petition for a Writ of Certiorari to this Court, as one of whether a federal agency receiver of a thrift "stand[s] strictly in a failed bank's shoes" for all purposes. *See* pp. 40, 41 and 44 of Appellants' Opening Brief and pp. 18-19 of Appellants' Reply Brief.

The coining of federal common law in this case would disrupt professional and commercial relationships[10] predicated under state law.[11]

2. *There Is No Federal Program or Rule of Law Requiring Uniformity*

Regarding the first criterion in *Kimbell Foods,* there is no federal program involved in the instant case which by its nature must be uniform in character throughout the nation. Congress enacted in FIRREA certain provisions providing to the FDIC and the RTC access to federal courts in damage actions,[12] providing a statute of limitations,[13] describing "recoverable damages," dam-

[10] A quite relevant commercial relationship common to many practicing lawyers involves the policies issued by professional insurance carriers to lawyers and law firms. It is appropriate to assume that both premiums and coverage would be affected drastically if the decision of the Ninth Circuit in this case remains controlling law. ABA Discussion Draft at 48-53, 266-71. *See also* Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions,* 66 So. Cal. L. Rev. 1019, 1069-72 (1993).

[11] The fact that the case is in a federal court, pursuant to specific statutory authority which deems that the matter arises under the laws of the United States, or the fact that specific types of tort claims may be assigned by a bank in receivership to a federal agency receiver under prior decisions applicable to the FDIC, does not change the nature of the underlying claim to that of a federal claim, with applicable, substantive federal law. *See Wichita Royalty Co. v. City National Bank,* 306 U.S. 103, 107 (1939), decided by this Court after *Erie R. Co. v. Tompkins,* 304 U.S. 64 (1938), which applied state substantive law, even though the case, after the receivership of a national bank, was removed from state court to federal court. *See also* the Rules of Decision Act, 28 U.S.C. § 1652, and U.S. Const. amend. X.

[12] *See* 12 U.S.C. § 1819(b)(2); 12 U.S.C. § 1441a(a)(11). Although the FDIC and RTC regularly contend that such jurisdictional provisions require that federal common law be applied, there is no case law from this Court supporting that position.

[13] 12 U.S.C. § 1821(d)(14).

ages in certain, limited agency suits against attorneys and accountants,[14] and indicating a standard of care for former officers and directors.[15] But Congress also incorporated in that connection state law when defining gross negligence and other terms.

FIRREA did not create a comprehensive statutory code for suits by the FDIC and the RTC against lawyers, and it is unnecessary for federal courts to fill in interstices by creating federal law to round out the federal program. This Court, in *Kamen v. Kemper Fin. Serv., Inc.*,[16] held that the court should look to state law as the law of decision even when a statute as comprehensive as the Investment Company Act of 1940 did not contain a provision regarding prior demand in a derivative action.

The Fourth Circuit, in an action instituted by the FDIC against lawyers, *inter alia*, pursuant to FIRREA, analyzed the *Kimbell Foods* criteria, in *FDIC v. Cocke*,[17] and found no basis for creating federal common law on the subject of adverse domination tolling the applicable state statute of limitations.[18] Such a conclusion is consistent with this Court's prior decisions regarding the law applicable to lawyers and the practice of law.[19] This Court has recognized

> that the States have a compelling interest in the practice of professions within their boundaries, and that as part of their power to protect the public health, safety, and other valid interests they have broad power to establish standards for licensing practitioners and regulating the practice of professions. . . . The interest of the States in regulating lawyers is especially great since lawyers are essential to the primary governmental function of administering justice, and have historically been "officers of the courts."[20]

[14] 12 U.S.C. § 1821(l). When overriding state law in FIRREA, Congress was clear about its intent. *See* 12 U.S.C. § 1821(c)(1) and (4).

[15] 12 U.S.C. § 1821(k).

[16] 500 U.S. ——, 111 S. Ct. 1711, 114 L. Ed. 2d 152 (1991).

[17] 7 F.3d 396 (4th Cir. 1993).

[18] 7 F.3d at 400.

[19] *See Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975).

3. *No Specific Objectives of a Federal Program Would Be Frustrated by Reliance on State Law*

The second prong of *Kimbell Foods* concerns the potential frustration of specific objectives of an alleged federal program. But in the federal program relevant to the instant case there is no such specific objective, unless one includes the objective of "maximizing recovery." One cannot blame a litigant, even a federal agency, for attempting to maximize its recovery, but that goal should not and, under decided cases of this Court, could not, authorize a court to ignore state law as the appropriate rule of decision.

If the FDIC, relying on *Kimbell Foods*, contends that all of the federal contacts with this matter in fact create a federal program, such is not the case for the following reasons:

a. *Three State-Chartered Subsidiaries of the Thrift, Which Themselves Are Not in Federal Institution Receivership, Are Plaintiffs in This Case*

Three of the four business plaintiffs—those most closely involved with the limited partnership, private placement transaction for which O'Melveny & Myers was retained as legal counsel—were state-chartered service corporations or partnerships to which none of the four FIRREA statutory provisions, discussed *supra*, applied.[21] These entities

[20] *Id.* at 792.

[21] *See* text at notes 12-15, *supra*. All of the operative facts of this matter occurred before FIRREA was enacted into law on August

could not be placed in a federal financial institution receivership and would not have been subject to the FIRREA provisions but rather would have been subject, if insolvent, to federal bankruptcy law. In fact, those plaintiffs have so little federal contact that there is a question as to how they properly remain as plaintiffs in this action in a federal court.[22]

b. *There Were Minimal Contacts with Federal Institutions in Receivership*

The Ninth Circuit incorrectly stated in its opinion that the FDIC, as the "receiver" of the thrift, sued O'Melveny & Myers. FDIC was merely a successor, as Manager of the FSLIC Resolution Fund,[23] to the FSLIC, and the operative facts did not occur when the FSLIC was the receiver of ADSB. FSLIC was acting as the conservator of ADSB in 1986, a different role, when it made the payments to investor/limited partners in the two partnership plaintiffs, American Diversified/Wells Park II, and

9, 1989, and the instant suit was filed before that date. We assume, however, for purposes of this brief, that the provisions of that statute apply to the parent thrift.

[22] This action was instituted in 1989, before the amendment to 28 U.S.C. § 1367, applicable to supplemental jurisdiction in actions instituted after December 1, 1990, became effective. Hence, no theory of pendant, ancillary or supplemental jurisdiction should apply. *See Aldinger v. Howard*, 427 U.S. 1 (1976), and *Finley v. United States*, 490 U.S. 545 (1989). In *Amerifirst Bank v. Bomar*, 757 F. Supp. 1365 (S.D. Fla. 1991), the court dismissed actions by the subsidiary service corporation of a thrift even though there was federal court jurisdiction over the suit by the parent thrift against former officers and directors. Claims against the officers, directors and counsel for a thrift, based on the claims of service corporation subsidiaries of the thrift, were dismissed in *FDIC v. Thompson & Knight*, 816 F. Supp. 1123, 1129 (N.D. Tex. 1993), currently on appeal to the Fifth Circuit, Nos. 93-1378 and 93-646.

[23] The FDIC was the successor in interest to assets and liabilities of the FSLIC, under the title of "Manager of the FSLIC Resolution Fund." 12 U.S.C. § 1821a(a)(1) and (2).

American Diversified/Gateway Center, which had sold limited partnerships and which had retained O'Melveny & Myers as their counsel. The settlement funds paid to the limited partner investors came from the thrift's first-tier subsidiary, American Diversified Capital Corporation —which is not a plaintiff in this case—and was paid out by plaintiff ADC Financial Corporation, a general partner in the Wells Park and Gateway Center projects.[24]

Thus, the alleged contacts of the entities in federal conservatorship or receivership with the transaction in litigation (the transaction in which O'Melveny & Myers provided legal advice) were tenuous, to say the least.[25]

[24] These facts are as described by the FDIC in Appellants' Opening Brief to the Ninth Circuit, at 9-11. The alleged damages in this case were not the damages of the investor/limited partners, who had assigned claims to the FSLIC, as conservator, but rather were the transactional costs of the FSLIC, in closing out the settlement with those investors, including the sale of real estate and the legal fees already paid to O'Melveny & Myers. *See* 969 F.2d at 752. The assignments in this case were not the typical assignments in FDIC cases, that is, not from the institution in receivership to the successor agency receiver. Rather, the assignments were from third parties, investors in third-tier subsidiary partnerships, and not persons referred to in the successor language in 12 U.S.C. § 1821(d)(2)(A)(i) (". . . all rights, titles, powers, and privileges . . . of any stockholder, member, accountholder, depositor, officer, or director of such [insured depository] institution . . . .").

[25] The Ninth Circuit did not cite its own decision in *Fidelity Financial Corp. v. Federal Home Loan Bank of San Francisco*, 792 F.2d 1432 (9th Cir. 1986), which involved a suit by a thrift holding company against the directors of the Federal Home Loan Bank of San Francisco, a federal instrumentality. Reversing the trial court on this issue, the Ninth Circuit indicated the limited circumstances in which formulating federal common law was appropriate:

> We need not reach the question of whether the [Federal Home Loan] Bank's actions measured up to a federal common law fiduciary duty, because we agree with the Bank that Fidelity had no such claim under federal common law. The in-

c. The Bases for Applying Federal Common Law in Certain Other Cases Involving the FDIC Are Not Present in This Case

The cases on which the FDIC relies for the application of "federal law" to its commercial bank receiverships involved discrete issues[26] and were based on the

stances in which federal courts may formulate federal common law are "few and restricted." *Wheeldin v. Wheeler*, 373 U.S. 647, 651, 83 S. Ct. 1441, 1444, 10 L. Ed. 2d 605 (1963). "[A]bsent some congressional authorization to formulate substantive rules of decision, federal common law exists only in such narrow areas as those concerned with the rights and obligations of the United States, interstate and international disputes implicating the conflicting rights of States or our relations with foreign nations, and admiralty cases." *Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 641, 101 S.Ct. 2061, 2067, 68 L.Ed.2d 500 (1981).

792 F.2d at 1437. The Ninth Circuit also did not cite another case involving the same thrift and the same or very similar issues, decided eight months earlier in *California Union Ins. Co. v. American Diversified Savings Bank*, 948 F.2d 556 (9th Cir. 1991). The FDIC was a party to this action (referred to throughout as the "FSLIC"), but the Ninth Circuit did not accept its legal argument that there should be no attribution of conduct of the two stockholders/directors/officers to the thrift. California law was treated as controlling. 948 F.2d at 558.

[26] *See, for example, D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 459-62 (1942) (codified in part in FIRREA in 12 U.S.C. § 1823(e) and 12 U.S.C. § 1821(d)(9)(A)); *Campbell Leasing, Inc. v. FDIC*, 901 F.2d 1244, 1248 (5th Cir. 1990) (federal holder in due course doctrine); *FDIC v. Main Hurdman*, 655 F. Supp. 259, 266 (E.D. Cal. 1987) (assignability of tort claim by bank to the FDIC); and *FDIC v. Bank of San Francisco*, 817 F.2d 1395, 1399 (9th Cir. 1987) (collection by FDIC on letter of credit). Although FDIC has made arguments in commercial bank receivership cases seeking to expand the issues on which federal courts should apply federal common law to create uniform, nationwide law, the Eleventh Circuit, in two cases, refused to expand the list. *See FDIC v. Harrison*, 735 F.2d 408, 412 (11th Cir. 1984) (equitable estoppel applied to FDIC), and *FDIC v. Jenkins*, 888 F.2d 1537 (11th Cir. 1989) (FDIC held not to have absolute priority over stockholders of bank in receivership); *but see Gaff v. FDIC*, 919

contention that when FDIC as receiver of commercial banks entered into purchase and assumption transactions with third parties who were acquiring the deposit liabilities and assets of a bank, the transaction had to be consummated quickly, and there was insufficient time to research state law to determine the value of certain assets or liabilities.[27] Thus, to the extent uniformity was required, federal courts have created individual, uniform federal common law rules.

Here, a conservator of a thrift caused payments to be made to investors in two of the thrift's subsidiaries and then sought recovery on a tort claim against legal counsel.[28] The circumstances of transactions which led federal courts to apply a uniform rule on specific issues in FDIC purchase and assumption transactions are absent in the instant case.

F.2d 384 (6th Cir. 1990), a case involving a national bank, which did apply federal law in circumstances similar to *Jenkins*, which involved a state-chartered bank.

The banking system in this country has been a dual system, controlled by both federal law and state law. Both Congress and the courts have respected this bifurcation and have moved carefully and methodically, whether the issue was branching, exercise of fiduciary powers by national banks or mergers pursuant to the Bank Holding Company Act.

[27] This procedure, upon which the FDIC has relied, is described in *FDIC v. Bank of Boulder*, 911 F.2d 1466, 1470-71 (including footnote 3), *opinion on rehearing en banc* (10th Cir. 1990), *cert. denied*, —— U.S. ——, 111 S. Ct. 1103, 113 L. Ed. 2d 213 (1991). The procedure also is detailed in *Gaff v. FDIC*, 919 F.2d 384, 385-86 n.1 (6th Cir. 1990).

[28] There is substantial authority for the contention that federal courts should not create federal common law in tort actions arising under state law. *See Bank of America Nat'l Trust & Savings Ass'n v. Parnell*, 352 U.S. 29 (1956).

II. THE FEDERAL RULE OF DECISION CREATED BY THE NINTH CIRCUIT IN THIS CASE IS FOUNDED ON BAD PUBLIC POLICY AND WOULD UNDERMINE THE APPROPRIATE ROLE OF LAWYERS IN REPRESENTING THEIR CLIENTS

A. The Ninth Circuit's Vaguely Defined "Duty of Care," Owed by a Lawyer Not Only to a Client That Is Defrauding the Lawyer But Also to Potential Third Party Successors to the Client, Would Have a Chilling and Cost-Raising Effect on the Lawyer-Client Relationship That Would Not Be in the Ultimate Interest of the Public

The opinion of the Ninth Circuit not only discusses an alleged duty of care by O'Melveny & Myers to the third-party investors (969 F.2d at 749), an alleged duty which is not directly at issue in this case because the investors' claims were settled, but that opinion also discusses alleged duties to the federal agency receiver for the thrift (969 F.2d at 752). This duty to the federal agency receiver apparently sprang to life upon the appointment of the agency as receiver or conservator. Thus, if there can be any likelihood that a conservator or receiver could be appointed, this unborn duty must be taken into account when advice is provided.

While superficially attractive, at least from the point of view of an agency laboring under the difficulties of regulating with scarce resources, placing a lawyer under a duty to anticipate the potential concerns of regulators even when the facts known to the lawyer do not suggest any regulatory impropriety would actually be counterproductive. The inevitable effect would be to diminish the ability of the lawyer to provide the client with the progressive representation that has become so important a part of modern business lawyering.

Banks and other financial institutions in the United States operate within a highly complex framework of statutes and regulations. They also conduct their business in a rapidly evolving and extremely competitive marketplace. Congress, in demarcating the balance of interests represented by its financial legislation, often deliberately chooses to leave open certain areas of the law for future development through experimentation and innovation.[29] While these "gaps" in the law are sometimes pejoratively labelled "loopholes," they not infrequently represent conscious, open-textured areas of legal ambiguity[30] where imaginative lawyering has enabled clients to adapt to changing market conditions.[31] Despite the vigorous protests of the regulators in some of these cases, the courts have upheld these efforts in many situations as perfectly legitimate extrapolations of prevailing law. Even where the lawyer's advice or advocacy has proven mistaken, the courts have not suggested that it should never have taken place at all. Our legal system *depends* on such progressive advocacy for its vitality.

The ABA does not of course suggest that a lawyer should ever be permitted to ignore applicable law or

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[29] For recent examples in the field of banking, *see, e.g., Securities Indus. Ass'n v. Board of Governors*, 900 F.2d 360 (D.C. Cir. 1990); *Securities Indus. Ass'n v. Board of Governors*, 847 F.2d 890 (D.C. Cir. 1988); *Securities Indus. Ass'n v. Board of Governors*, 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988); and *Securities Indus. Ass'n v. Board of Governors*, 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) (courts accepting narrow construction of the Glass-Steagall Act as a means of permitting banks to engage in a wide range of securities underwriting and dealing).

[30] This Court, in *Board of Governors v. Dimension Fin. Corp.*, 474 U.S. 361 (1986), was insistent that banking statutes be construed carefully by courts and regulators so as not to upset the delicate compromises delineated by Congress in those statutes. *Id.* at 374.

[31] Congress, of course, retains the power to override these developments where it believes them to be inappropriate, and it has proven able and willing to do so. *See, e.g.*, the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987), in which Congress overrode the effects of the ruling in the *Dimension Financial* case, *supra*.

regulations, or aid or counsel actions that the lawyer has reason to believe would be in violation of the law. But if the consequence of honest but mistaken lawyering were that the agency could subsequently argue that the lawyer had violated a duty *to the agency*, or if the agency could argue that the lawyer had a duty to ferret out fraudulent misrepresentations by the client *even where the lawyer has no reason to suspect this fraud*, a prudent lawyer would be driven to one of two courses of action: either the lawyer would simply refuse to represent the client at all, or the lawyer would ensure that any advice or assistance he or she might give, wherever there was any conceivable doubt regarding the state of the law, should always err in the direction of the views the lawyer believes the agency might take.

Neither option is appropriate to a legal system such as ours that embraces—indeed depends upon—robust and progressive (albeit responsible) legal representation of clients, whether they be individuals or corporations. The restrictive and cautious model of lawyer responsibility represented, in effect, by the duty fashioned by the Ninth Circuit in the instant case will not serve the public well in the long run.

B. Lower Courts, Taking Into Account the Broader Public Issues at Stake, Have Rightly Rejected the Efforts by the FDIC to Resort to Federal Common Law as an Expedient in Litigation

The case currently before this Court involves an attribution issue, that is, does the federal agency receiver stand in the shoes of the predecessor thrift, however muddy those shoes may be, or can the federal agency receiver shed any unwanted "baggage," including unwelcome obligations, while enforcing rights against third parties? The FDIC, however, has not been limiting its claims to a favorable federal common law merely to that issue or to the different issues described above in which federal common law was created or applied by courts primarily

to FDIC purchase and assumption transactions involving commercial banks. In the following cases, primarily involving thrifts, the agency receivers made broad-ranging claims that federal law should apply. The courts generally have not accepted the contention of the FDIC that they should apply federal law, rather than state law, as the rule of decision, to cut off or limit state court defenses of professionals.

The FDIC contended in *FDIC v. Clark*,[32] a claim against a lawyer on behalf of a defunct commercial bank, that the Colorado Proportionate Liability Statute should not apply, claiming that federal common law should "overrule" that state statute. The Tenth Circuit did not agree.[33] In *FDIC v. Ferguson*,[34] the FDIC contended that comparative and contributory negligence, defenses under Oklahoma law, should not be allowed as a defense in a suit against a lawyer for a thrift because of "public policy considerations."[35] The Tenth Circuit refused to follow the FDIC's public interest argument that those defenses should be barred.[36] The FDIC contended in *FDIC v. Cocke*,[37] a lawyer malpractice claim, that federal common law, not Virginia law, should be applied to the issue of whether the Virginia statute of limitations had been tolled. The Court of Appeals for the Fourth Circuit, citing the *Kimbell Foods* case and applying its analysis,[38] refused to accept this contention.[39]

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[32] 978 F.2d 1541 (10th Cir. 1992).

[33] 978 F.2d at 1551-52.

[34] 982 F.2d 404 (10th Cir. 1991).

[35] 982 F.2d at 406.

[36] 982 F.2d at 407-08.

[37] 7 F.3d 396 (4th Cir. 1993).

[38] 7 F.3d at 400. *See also FDIC v. Dawson*, 4 F.3d 1303, 1308-09 (5th Cir. 1993), in which the Fifth Circuit applied state law on the issue of adverse domination in an FDIC suit against the former officers and directors of a thrift.

[39] The FDIC, in its Brief for Appellee at 13, 16-21, *FDIC, as Receiver for New Bank of New England, N.A. v. Marine Midland*

The FDIC clearly does not limit its argument about creating federal common law to maximize recovery only in cases involving the kinds of factual issues that under-

Realty Credit Corp., Nos. 92-1019 and 92-1020 (4th Cir. 1993), contended in its appellate brief, that by applying federal law rather than state law, it could assign the asset component of a contract to a successor institution while retaining the liability component of the same contract in the receivership. Thus, the successor could enforce against the other contracting party the latter's responsibilities under the contract while the contracting party has access only to the receivership to enforce the bank's responsibilities under the same contract. Such a result provides a powerful incentive for the FDIC to seek to displace state law.

The RTC has made similar assertions. In its claim against a law firm in *RTC v. Latham & Watkins*, 93 Civ. 4364 (MBM) (S.D.N.Y.), the RTC contended in its Memorandum of Law in Opposition to Defendants' Motion to Dismiss the Complaint Pursuant to Federal Rule 12(b)(6), on the issue of whether the RTC properly could pursue claims of the subsidiary corporations of the thrift:

> Defendants are wrong. The RTC is not a garden-variety private corporation organized under state law to generate profits for its shareholders. To the contrary, the RTC's genesis is FIRREA, which Congress enacted.

Id. at 75. The RTC went on to argue that it is

> not bound by the formalities of state corporation law in protecting and preserving the assets of failed institutions and their wholly owned subsidiaries . . . .

Id. at 76.

The trial judge, in his ruling, did not accept this argument. Decision of Judge Mukasey, December 2, 1993, at 12-13. *Bank Lawyer Liability*, Buraff Publications, Washington, D.C., pp. C-6 - C-7 (Jan. 7, 1994). Judge Mukasey stated:

> The RTC has asserted claims in behalf not only of entities for which it has been authorized to act as receiver but also on behalf of the wholly owned subsidiaries of those institutions. The RTC has argued that the broadly remedial purpose of FIRREA permits it to do that.
>
> There is nothing in the statute that overrides the corporate form of separate legal entities or permits the RTC or this court at will to disregard the separateness of those entities. In this respect I follow and endorse Judge Leval's ruling on precisely

lie the instant case and in *FDIC v. Ernst & Young*,[40] but has also made the argument in numerous other cases involving lawyers wherever application of state law would or could limit the agency's recovery.

CONCLUSION

Under the criteria of *Kimbell Foods*, and other Supreme Court authority, the Ninth Circuit should not have displaced state law by a federal common law rule of decision. There is no comprehensive federal program that must be implemented by a court with uniform federal common law.

The agency receivers are relying on *state law causes of action*, while pursuing their claims in federal courts pursuant to congressional grants of *jurisdiction*. But there are no congressional grants of *federal causes of action*,

> the same point in *In re Frost Brothers Incorporated*, 91 Civ. 5244 (PNL), reported at 1992 U.S. LEXIS 18301, Southern District of New York, December 2, 1992.
>
> The practical effect of this ruling is to bar any claims asserted in behalf of Liberty Service Corporation, a wholly owned subsidiary of Columbia Savings and Loan Association, and American Capital Fidelity Corp., a wholly owned subsidiary of FarWest Savings and Loan Association.

[40] 967 F.2d 166 (5th Cir. 1992). *See also* the response of the U.S. District Court in *FDIC v. Day*, 148 F.R.D. 160, 177 n.23 (N.D. Tex. 1993), to the arguments of the FDIC about its "superpower" status:

> FDIC and its attorneys have repeatedly reminded the court of special treatment FDIC and its related agencies have received from the courts, including what have become known as the "superpower" defenses. The court recognizes that FDIC is afforded something of a special status; and the court has taken into consideration in the court's findings and conclusions the decisions that have favored FDIC in those respects. Also, the court has noted that there is a limit on how far the courts will go to further the interests of FDIC. *See, e.g., Federal Deposit Ins. Corp. v. Ernst & Young*, 967 F.2d 166 (5th Cir. 1992).

and none should be implied, merely because the federal courts have been vested with jurisdiction.

The "certainty of the law" evaporates if legal advice, and the consequences to legal counsel for providing such advice, are controlled not by state law but by whatever the FDIC urges is "the law," a law tailored only to maximizing recovery in tort actions, years after legal advice was given. Such a result could have a deadening effect on zealous representation by legal counsel and could result in certain classes of clients—those which might enter into a federal agency receivership—not being represented. On a cost/benefit basis, the risk to practicing lawyers of exposure to after-the-event, newly coined, "federal common law," might well outweigh any incentive to represent the client at all or in a manner appropriate to a dynamic legal and financial system.

Respectfully submitted,

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No. 93-489

In The

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October Term, 1993

O'MELVENY & MEYERS,

Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ET AL.,

Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

BRIEF FOR SHRADER & YORK, SHRADER, YORK, CLOTE, HINDS AND GROTE, P.C., SHRADER, CLOTE, HINDS AND GROTE, P.C., WILLIAM E. YORK, WILLIAM C. SHRADER, PAUL D. CLOTE, GARY E. GROTE AND ELDON HINDS AS AMICI CURIAE IN SUPPORT OF NEITHER PARTY

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INTEREST OF THE AMICI CURIAE

This Court granted review in this case based upon representations by both Petitioner and Respondents that the Ninth Circuit's decision in *O'Melveny* conflicted with *FDIC v. Shrader & York*, 991 F.2d 216 (5th Cir. 1993), petition for cert. pending, No. 93-651. Amici Shrader &

York, et al. are respondents in *Shrader & York* and have filed a brief in opposition to the petition for writ of certiorari in that case. Their interest here is that the parties in this proceeding have broadly equated *O'Melveny* with *Shrader & York* in terms of the issue presented. These amici do not believe there is in fact any conflict because the issues presented in the two cases are significantly different. Indeed, the decision in *Shrader & York* followed longstanding Supreme Court precedent, and nothing in *O'Melveny* suggests that the Ninth Circuit intended to diverge from or to assail that precedent. However, it is unlikely at this point that the distinction will be drawn by the parties here. These amici are therefore interested that, whatever the decision in *O'Melveny* ultimately is, it address only the precise issue presented to the Court. The parties here have consented to the filing of this brief.

ARGUMENT

The parties obtained review in this Court on the basis of a conflict between the Ninth and the Fifth Circuits. These amici do not believe that the asserted conflict actually exists. *O'Melveny*, in an alternative holding, addresses whether substantive defenses, presumed good against the thrift, are nonetheless unavailable to defeat the claim after assignment to the FDIC. *Shrader & York*, a limitations case, directly addresses whether a claim was barred by limitations before it was assigned to the FDIC. The Ninth Circuit cases addressing the same limitations issue do not conflict; they agree.

O'Melveny involves no question of limitations. Instead, in an alternative holding, the Ninth Circuit stated that, when the FDIC as receiver acquires a claim, the determination of what substantive defenses can be interposed to defeat the merits of that claim is a question of federal law. *O'Melveny*, 969 F.2d at 751. Without regard to the correctness of that proposition, it is not in conflict with the Fifth Circuit's ruling on limitations and the application of state law.

Indeed, the decisions of both the Fifth and Ninth Circuits on that issue agree and are in accord with long-standing Supreme Court precedent. In *Guaranty Trust Co. v. United States*, 304 U.S. 126 (1938), this Court held that a claim, time-barred under the state law that created it, is not revived by subsequent assignment to a federal agency: The federal agency "never acquired a right free of a pre-existing infirmity, the running of limitations against its assignor, which public policy does not forbid." *Id.* at 142.

It is now "settled law" that a federal court, when presented with the question of the viability of a claim assigned to the FDIC, must determine whether, under state law, limitations expired before transfer to the agency. *FDIC v. Former Officers and Directors of Metropolitan Bank*, 884 F.2d 1304, 1309 at n.4 (9th Cir. 1989) (citing and quoting *Guaranty Trust Co.*, 304 U.S. at 126), *cert. denied sub nom, Lee v. FDIC*, 496 U.S. 936 (1990); *FDIC v. Dawson*, 4 F.3d 1303, 1309 (5th Cir. 1993)(The "issue is whether the bank would be time-barred if it tried to sue its directors in state court on the date of the FDIC's appointment as receiver."); *FDIC v. McSweeney*, 976 F.2d 532, 534 (9th Cir. 1992), *cert. denied*, 113 S.Ct. 2440 (1993)

("The FDIC may not, however, revive claims for which the state limitations period has expired before the date of federal receivership."). Had the *O'Melveny* court been presented with the same issue, that is whether the claim was barred under state law before it was acquired by the FDIC, *Metropolitan Bank* and *McSweeney* would have dictated a result precisely the same as that reached by the Fifth Circuit.

CONCLUSION

None of the parties in this proceeding has suggested that this Court overrule *Guaranty Trust Co. v. United States*, 304 U.S. 126 (1938). Indeed, the limitations issue has not been raised. The parties have, however, phrased their briefing in broad terms which neither recognize nor account for the significant difference between the issue presented in *O'Melveny* and that presented in *Shrader & York*. These amici believe that the decision of this Court, whatever it may be, should not be equally broad but instead should address only that which has actually been presented here.

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No. 93-489 (13)

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QUESTION PRESENTED

Whether it is appropriate to create a federal common law rule that retroactively alters traditional principles of attorney professional liability solely for the purpose of maximizing the asset pool of a federal agency.

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BRIEF AMICUS CURIAE OF BANKING AND BUSINESS LAWYERS IN SUPPORT OF PETITIONER

INTEREST OF AMICI CURIAE

The undersigned *amici curiae* are banking and business lawyers from all over the United States each of whom has many years of experience in representing federally insured depository institutions ("IDIs") and their holding companies and affiliates. *Amici* have been active in organized Bar activities at the State and local level as

well as at the national level, including the Federal Bar Association and the American Bar Association ("ABA"),[1] and are committed to the provision of the highest quality legal services consistent with the best ethical traditions of the profession. *Amici* have been actively involved in the study, discussion, and debate—whether in print or in private or public fora—of ethical and policy questions concerning the duties of counsel representing IDIs that have arisen in the wake of the failure of thousands of such institutions during the 1980's and 1990's. The issues presented in this case directly address the role that lawyers play in the administration of justice when serving as counsel for a wide variety of business entities, including federally and state-chartered commercial banks, savings banks, savings and loan associations, as well as thrift and loan companies, industrial loan companies, credit unions, and the like.

Here the Federal Deposit Insurance Corporation ("FDIC"), acting as statutory successor to the defunct Federal Savings and Loan Insurance Corporation ("FSLIC"),[2] wishes to impose malpractice liability upon a law firm (in this case the firm of O'Melveny & Myers ("O'Melveny")) when, unbeknownst to the law firm, its client had perpetrated a fraud upon third parties. In the wake of the savings and loan debacle and the FSLIC insolvency, FDIC and its counterpart, the Resolution

[1] Although many of the *amici* have been extremely active in the ABA and various other bar associations, and several chair Committees, Subcommittees, and Task Forces thereof, this brief is not being sponsored or filed by any of those organizations and does not necessarily represent their views.

[2] As correctly noted by the court below, the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989) ("FIRREA"), *inter alia* abolished the FSLIC, transferred its assets and liabilities to the FSLIC Resolution Fund (managed by FDIC), and caused FDIC to be substituted for FSLIC as the party in interest in cases of this kind.

Trust Corporation ("RTC"),[3] have come under increased scrutiny and political pressure from Capitol Hill to speed up the process of resolving failed institutions and recover damages from wrongdoers to defray the enormous public expense of the thrift bailout. This case is one of a series of cases brought by FDIC or RTC involving claims—typically arising under State tort or contract law—against professionals (including attorneys and accountants) where the same State law that creates the cause of action would either bar the claim or give rise to certain affirmative defenses but where the FDIC, in order to avoid this result, asks the court to disregard State law and create a new federal common law rule of decision that would resuscitate an otherwise barred claim or negate established State law defenses. In many instances, as here, the result is to create new duties and obligations which do not exist under State law, certainly did not exist at the time of the conduct complained of, and were unforeseeable by the professional firms involved.

Amici are concerned about the threat to our system of State regulation of the Bar—and indeed to the attorney-client relationship itself—posed by the sort of selectively and retroactively imposed liability "legislated" by judges under the putative authority of federal common law, as exemplified by this case. If the mere presence of FDIC as receiver in a case can change the controlling law governing professional liability, then counsel for IDIs would feel themselves obliged to be looking over their own shoulders every time they are called upon to provide legal services. Worse yet, the imposition of a separate duty owed by counsel to constituencies other than the client raises the spectre of conflict of interest in even routine transactions. There would, in short, be a chilling

[3] RTC is a mixed ownership government corporation created by Congress in FIRREA for the purpose of managing and resolving IDIs previously insured by FSLIC. In general, RTC and FDIC enjoy the same case resolution rights and powers.

effect on the ability of the banking bar to provide totally disinterested advice and to represent their clients zealously.

Moreover, the cost and availability of legal services to IDI clients would be adversely affected. Even if the proliferation of claims against law firms does not, of itself, impel a number of firms currently providing legal services to IDIs to leave the market, the increasing cost and diminishing availability of malpractice insurance may lead to that result. Those firms that remain will, of necessity, be forced to charge higher fees for such services and may well find it prudent not to represent IDIs in financial difficulty or with low net worth because of the increased risk of failure and the appointment as receiver of an agency that feels compelled to look to every "deep pocket" as a potential defendant from which to recover money damages. Therefore, clients that need quality legal services the most may often be unable to find them or afford them if found.

These issues—lawyers' ethical obligations, the integrity of the attorney-client relationship, and the cost and availability of legal services—are of great concern to the legal profession, and the perspective of *amici* on these issues should be of assistance to the Court.[4] Moreover, apart from the impact of the decision below upon an individual law firm, the inappropriate fashioning of federal rules of decision to benefit the interests of a single, albeit frequent, litigant in the court system has broader ramifications for the administration of justice and therefore implicates core concerns of *amici*, who have considerable experience with both banking law and regulation[5] and the judicial process.

[4] This brief *amicus curiae* is filed with the consent of the parties. Copies of their consent letters are on file with the Clerk of the Court.

[5] Several of the amici have participated in two ABA-affiliated groups that have heretofore issued reports analyzing, *inter alia*, the responsibilities of counsel in the context of claims advanced by the federal bank regulators. *See* ABA WORKING GROUP ON LAWYERS' REPRESENTATION OF REGULATED CLIENTS, LABORERS IN DIFFERENT VINYARDS? THE BANKING REGULATORS AND THE LEGAL PROFESSION (Discussion Draft, Jan. 1993) [hereinafter *"Working Group Report"*]; CHAIRMAN'S EXPOSURE DRAFT, TASK FORCE ON THE LIABILITY OF COUNSEL REPRESENTING DEPOSITORY INSTITUTIONS (First Interim Report, Aug. 3, 1992), *reprinted in* 9 BANK AND CORPORATE GOVERNANCE LAW REPORTER 980 (1992) [hereinafter *"Task Force Report"*].

SUMMARY OF THE ARGUMENT

The court below, without analysis or even acknowledgment of this Court's recent federal common law jurisprudence, disregarded the legitimate interests of the States in regulating the professional conduct of lawyers and created a novel federal common law duty that disrupts commercial relationships between lawyers and their clients. In so doing, the court ignored State law defenses which California allows defendants to interpose against the State law claim brought by FDIC herein, all for the sole, avowed purpose of maximizing FDIC's recoveries in litigation.

The duty created by the court below is not only unprecedented but also ill-conceived. A duty by an IDI's counsel to depositors or to the government muddies the duty of undivided loyalty to the client and threatens to create conflicts in a large number of routine transactions. It will also have a chilling effect on counsel's ability to represent an IDI client in "cutting edge" transactions. Having to look over one's shoulder in fear of potential liability should the client fail and FDIC become receiver will impair that independence and detachment which are among the principal values of the attorney-client relationship.

Finally, the decision below has a deleterious impact on the availability, cost, and coverage of legal malpractice insurance and, as a consequence, on the cost and availability of legal services to IDIs. The long-term costs of

disrupting settled professional and commercial expectations heretofore governed by State law far outweigh any short-term benefit to the taxpayers from maximizing FDIC's asset pool.

ARGUMENT

I. REGULATION OF THE LEGAL PROFESSION IS TRADITIONALLY WITHIN THE PURVIEW OF THE STATES.

At the request of a single, albeit frequent, litigant habitually claiming broad powers to act in the public interest, the court below fashioned a novel duty of counsel—despite the lack of any basis for suspicion—to investigate and discover whether an IDI client is engaging, or has engaged, in fraudulent activities and, if so, to disclose the same to potential investors. Purporting to rely on California law as the source for this duty, the court in fact cited no California authority whatever for such a proposition and instead created a duty predicated on *federal* law. The court then went on to create federal rules of decision to deprive O'Melveny of State law defenses against FDIC's malpractice claims, because "federal, not state, law governs the application of defenses against FDIC," Pet. App. 13a, FDIC did "not voluntarily step into [ADSB's] shoes" but "was thrust into them," *id.* at 14a, and allowing the State law defenses would diminish the value of FDIC's asset pool, *id.* at 15a.

In so doing, the court below ignored the legitimate interests of the States in regulating the professional conduct of lawyers, ignored the principles of State law that establish the duty of counsel, ignored the defenses which the State allows defendants to interpose against the claim brought by FDIC that itself sounds in State tort law, and ignored this Court's decisions expounding on federal common law and the propriety of creating it.

This Court has frequently recognized

> that the States have a compelling interest in the practice of professions within their boundaries, and that as part of their power to protect the public health, safety, and other valid interests they have broad power to establish standards for licensing practitioners and regulating the practice of professions * * * * The interest of the States in regulating lawyers is especially great since lawyers are essential to the primary governmental function of administering justice, and have historically been "officers of the courts." [*Goldfarb v. Virginia State Bar,* 421 U.S. 773, 792 (1975), citing *Sperry v. Florida ex rel. Florida Bar,* 373 U.S. 379, 383 (1963); *Cohen v. Hurley,* 366 U.S. 117, 123-124 (1961); *Law Students Research Council v. Wadmond,* 401 U.S. 154, 157 (1971).]

The testing, licensing, and admission to practice of a lawyer, the standards of professional conduct governing the practice of law, and the enforcement of those standards by appropriate disciplinary proceedings are all under the control of the States and their respective judiciaries. "[T]he regulation of the activities of the bar is at the core of the State's power to protect the public," *Bates v. State Bar of Arizona,* 433 U.S. 350, 361 (1977), and is "a sovereign function of the [State's] Supreme Court." *Hoover v. Ronwin,* 466 U.S. 558, 569 n.18 (1984).[6]

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[6] Indeed, though its luster has dimmed since this Court's decision in *Garcia v. San Antonio Metro. Transit Auth.,* 469 U.S. 528 (1985), the Tenth Amendment is still thought by important scholars to be the Constitution's expression of protection for such traditional State functions and essential attributes of State sovereignty. *See, e.g.,* William Van Alstyne, *The Second Death of Federalism,* 83 MICH. L. REV. 1709 (1985). It is one thing for the Congress, a representative and politically accountable branch of government, to intrude into this realm by legislation; it is quite another for the federal judiciary to intrude by creating federal common law.

II. THERE IS NO BASIS IN LAW FOR THE CREATION OF A FEDERAL COMMON LAW DUTY TO INVESTIGATE

Explicit in this Court's decisions from and including the landmark *Erie* decision is that statutes granting federal jurisdiction do not constitute enabling authority for a federal court to make federal common law and that there must be some separate source of authority for such a rule. *See, e.g., Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 640-41 (1981). This principle has both a constitutional and a statutory dimension.[7] In the words of Justice Brandeis:

> Except in matters governed by the Federal Constitution or by Act of Congress, the law to be applied in any case is the law of the State * * * * There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a State whether they be local in nature or "general," be they commercial law or part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts * * * * "Supervision over either the legislative or the judicial action of the States is in no case permissible except as to matters by the Constitution specifically authorized or delegated to the United States. Any interference with either, except as thus permitted, is an invasion of the authority of the State and, to that extent, a denial of its independence." [*Erie R. v. Tompkins*, 304 U.S. 64, 78-79 (1938) (quoting *Baltimore & O.R.R. v. Baugh*, 149 U.S. 368, 401 (1892)).][8]

[7] The statute is the very one at issue in *Erie* itself, the Rules of Decision Act, which currently provides, "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States where they apply." 28 U.S.C. § 1652 (1982). The only textual difference between this language and the original version in the Judiciary Act of 1789 is that the Act now extends to "civil actions" rather than merely to "trials at common law." The explicit reach of the statute has thus been expanded since original passage, though the case at bar, sounding in common law tort, would have been covered by the earlier version as well.

In *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728-729 (1979), this Court established a three-pronged test for creating federal common law: (i) whether the court is dealing with federal programs that "by their nature are and must be uniform in character throughout the Nation"; (ii) whether application of State law would frustrate specific objectives of the federal program; and (iii) whether application of a federal rule would not disrupt commercial relationships predicated on State law. None of these criteria is triggered in a case involving a malpractice claim by the assignee of a California state-chartered IDI against a law firm that represented state-chartered subsidiaries of the IDI.

A. Bank Receiverships Are Not A Federal Program Requiring Uniformity

The mere existence of a scheme of federal regulation does not give rise to a need for uniformity. Even as comprehensive a scheme as the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, which confers regulatory power to one federal agency but does not expressly deal with prior demand in a derivative action under State corporate law, was not regarded by this Court as justifying the creation of federal common law that does not incorporate the State law rule. *Kamen v. Kemper Fin. Serv., Inc.*, 111 S. Ct. 1711 (1991). Banking regulation presents an *a fortiori* case, inasmuch as Congress has long

[8] *Accord Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 641-642 (1981) (federal courts may not fashion federal common law rule of contribution even under antitrust laws—a federally created cause of action—because, while there is a federal interest in the appropriateness of contribution, this is not the type of "uniquely federal interest" that would support federal common law).

recognized—and left intact—a dual system of regulation by the states and by not one, but several, federal agencies, where in many instances the latter—and even federally created IDIs such as national banks—are bound by State law restrictions.[9]

Congress has the power to alter this scheme and has done so in specific instances. For example, in FIRREA Congress amended the Federal Deposit Insurance Act, 12 U.S.C. § 1811 *et seq.*, to preempt State law (A) that might otherwise forbid or impede FDIC from effecting emergency acquisitions of failing IDIs[10] or from accepting appointment to act as conservator or receiver for any IDI;[11] (B) that establishes a statute of limitations of less than 6 years for contract claims or 3 years for tort claims in actions brought by FDIC;[12] (C) that would

[9] Some examples, apart from obvious ones such as chartering, supervision and examination, are the "competitive equality" effected by the McFadden Act, 12 U.S.C. § 36(c), between the branching powers of national and state banks, *see First Nat'l Bank in Plant City v. Dickinson*, 396 U.S. 122 (1969); *First Nat'l Bank of Logan v. Walker Bank & Trust Co.*, 385 U.S. 252 (1966); exercise of fiduciary powers by national banks when not in contravention of State law, 12 U.S.C. § 92a(a); and state power to override the prohibition in the Douglas Amendment to the Bank Holding Company Act, 12 U.S.C. § 1842(d), against interstate ownership of banks by bank holding companies, *see Northeast Bancorp. v. Board of Governors*, 472 U.S. 159 (1985); *Whitney Nat'l Bank v. Bank of New Orleans & Trust Co.*, 379 U.S. 411 (1965).

[10] FIRREA § 217(8), adding a new subsection (k) to § 13 of the Federal Deposit Insurance Act, 12 U.S.C. § 1823(k).

[11] FIRREA § 212(a), amending § 11(c) of the Federal Deposit Insurance Act, 12 U.S.C. § 1821(c).

[12] FIRREA § 212(a), adding subsection (d)(14) to § 11 of the Federal Deposit Insurance Act, 12 U.S.C. § 1821(d)(14).

In their zeal to maximize recoveries, both FDIC and RTC have frequently argued that § 11(d)(14) resurrects claims that have expired under State law prior to the conservatorship or receivership, but the lower federal courts have consistently rejected that position. *See, e.g., FDIC v. Regier, Carr & Monroe*, 996 F.2d 222

permit damages in excess of "actual direct compensatory damages" (*e.g.*, punitive damages, damages for pain and suffering) as liability for FDIC's repudiation of certain executory contracts.[13] Thus where Congress wanted uniformity, it enacted uniformity.

In contrast, while FIRREA contemplates professional liability suits by FDIC, nowhere in FIRREA or in any other statute has Congress created a comprehensive federal standard to govern such suits. To the contrary, FIRREA expressly contemplates the application of State law. For example, FDIC may seek to recover damages from directors and officers "for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, *as such terms are defined and determined under applicable State law.*"[14]

B. Application of State Law Would Not Frustrate Specific Objectives of a Federal Program

From the foregoing, one can see that merely maximizing FDIC's recoveries or, in the words of the court below, "the value of FDIC's asset pool," Pet. App. 15a, however desirable for an agency under pressure from a deficit-conscious legislature, has never been seen by Congress as a justification for displacing State law. In providing additional powers to FDIC, Congress has been careful to limit preemption of State law to those situations where it would threaten the *orderliness of the process.* Thus protecting from State law challenge the agency's authority to effect last-minute, emergency acquisitions of

(10th Cir. 1993); *Randolph v. RTC*, 995 F.2d 611 (5th Cir. 1993); *FDIC v. McSweeney*, 976 F.2d 532 (9th Cir. 1992), *cert. denied*, 113 S. Ct. 2440 (1993); *RTC v. Greenwood*, 798 F. Supp. 1391 (D. Minn. 1992); *RTC v. Gardner*, 788 F. Supp. 26 (D.D.C. 1992).

[13] FIRREA § 212(a), adding new subsection § 11(e) to the Federal Deposit Insurance Act, 12 U.S.C. § 1821(e).

[14] FIRREA § 212(a), adding new § 11(k) to the Federal Deposit Insurance Act, 12 U.S.C. § 1821(k) (emphasis supplied).

failing IDIs, creating a federal statute of limitations so the receiver has adequate time to evaluate potential lawsuits and determine whether to bring them, and permitting the receiver to repudiate burdensome executory contracts entered into by a now defunct IDI without liability for exemplary damages are all reasonable accommodations designed to facilitate the *orderly resolution* of hundreds of failed institutions with billions of dollars of assets. That is the fundamental objective of this federal program. Creating federal common law to fill in the interstices of the Federal Deposit Insurance Act is only justified when it serves this objective.[15]

The facts of the instant case present no justification for creating federal common law. Three of the four business plaintiffs, those most closely involved with retaining O'Melveny as legal counsel, were state-chartered service corporations, partnerships, or joint ventures to which none of FIRREA's statutory provisions applies. These entities could not legitimately be placed in FSLIC or FDIC receivership but would be subject, if insolvent, to the federal bankruptcy code.[16] Moreover, when in 1986 FSLIC,

[15] Cases like *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), where this Court created a federal common law rule to protect the receiver from secret side agreements with borrowers not appearing on the books of the failed bank, and thereby jeopardizing the receiver's ability to bring about orderly resolution of the institution's assets and liabilities, are consistent with this overarching purpose.

[16] In fact, it is doubtful under this Court's precedents whether there is federal jurisdiction over these entities. *See Finley v. United States*, 490 U.S. 545 (1989); *Owen Equipment & Erection Co. v. Kroger*, 437 U.S. 365 (1978); *Aldinger v. Howard*, 427 U.S. 1 (1976). Lower courts have declined to exercise pendent party jurisdiction in contexts similar to the instant case. *See, e.g.*, *Amerifirst v. Bomar*, 757 F. Supp. 1365, 1375 (S.D. Fla. 1991) (dismissing claims by IDI's service corporation subsidiary even though there was federal jurisdiction over suit by parent IDI). *Cf. FDIC v. Thompson & Knight*, 816 F. Supp. 1123, 1129 (N.D. Tex. 1993), *appeal pending*, Nos. 93-1378 & 93-646 (5th Cir., filed April 22, 1993) (FDIC lacks standing to bring or pursue claims of IDI's subsidiaries).

as conservator of ADSB, decided to pay off the investors/limited partners[17] in the two joint venture plaintiffs, American Diversified/Wells Park II and American Diversified/Gateway Center, the settlement funds came not from the assets of the thrift but from another first-tier subsidiary, American Diversified Capital Corporation (interestingly, not a plaintiff in this case) and were actually paid out not by ADSB but by ADC Financial Corporation, a general partner in the Wells Park and Gateway Center projects.[18] Thus the alleged contacts of entities properly implicated in any federal program with the transaction in question—the only transaction in which O'Melveny provided legal services—were at best remote.

C. Application of a Federal Rule Would Disrupt Commercial Relationships Predicated on State Law

The third prong of the *Kimbell Foods* analysis also militates strongly against the creation of federal common law in this case. While the practice of law itself is a profession and the relationship of attorney and client is special and subject to professional privilege, that relationship is also a commercial relationship: it is typically created via an engagement letter from the attorney to the client, acknowledged and agreed to by the latter, pursuant to which a fee will be paid for the attorney's services. Negligent performance by the attorney subjects

[17] These investors are not among the group Congress has specified to whose rights, titles, powers, and privileges FDIC may properly succeed; that group consists only of the IDI itself and "any stockholder, member, accountholder, depositor, officer, or director." 12 U.S.C. § 1821(d)(2)(A). So the Ninth Circuit's observation that "the receiver becomes the bank's successor as part of an intricate regulatory scheme designed to protect the interests of third parties," Pet. App. 14a, is a red herring: the court is dealing with the wrong third parties.

[18] These facts are as described by FDIC in Appellants' Opening Brief to the Ninth Circuit, at 9-11.

him to liability under State law, a risk against which the attorney normally carries malpractice insurance. In some States, the client's cause of action sounds in tort, in others it sounds in contract or even breach of warranty. The relationship between a large law firm and its client is no different from that of a solo practitioner and his or her client, and it makes no difference whether the client is an unsophisticated individual or a large corporation that is a frequent and savvy consumer of legal services; the standard of care is the same and the understanding between the parties as to the client's fee obligations and the duties and ethical obligations of counsel are all essentially the same. In all instances there is a commercial relationship predicated upon and governed by State law.

Here O'Melveny, whose principal office is in California, provided legal advice to the California-chartered subsidiaries of a California-chartered thrift institution. That legal advice presumably was based in large part on California law, including California corporate, partnership, and real estate law. The firm and the client each would safely have assumed, particularly in 1985, that O'Melveny's professional responsibilities were governed by the law of the State of California, which controlled admission, practice, supervision, and discipline of lawyers licensed and practicing in California.

There is simply no way O'Melveny—or any other law firm—could have rationally conducted its business on the assumption that, years later, its professional obligations to these state-chartered subsidiaries would become governed, upon the failure of the parent thrift, by novel federal law created by a federal court in 1992. Strikingly, even FDIC did not take the position that these 1985 relationships were governed by federal common law until filing its reply brief in the Ninth Circuit, and there the matter was alluded to only in footnotes.[19]

[19] Both in its opening brief (at pp. 40, 41, and 44) and its reply brief (at pp. 18-19, nn. 17-18) in the court below, FDIC characterized the legal issue, as it has, in effect, done before this Court in its Brief in response to the Petition for a Writ of Certiorari, as one of whether a federal agency receiver of a thrift "stands in the shoes of the thrift" for all purposes.

The claim advanced by FDIC in this case—legal malpractice—is a classic, State law tort claim. Like all tort claims, it requires the plaintiff to establish the breach of an actionable duty. The creation *post hoc* of a novel, federal common law duty that is not only different from, but at odds with, what lawyers have traditionally understood their responsibilities to be cannot help but disrupt the traditional relationships, predicated on State law, that lawyers and law firms everywhere have established with their clients for many years.

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In short, the court below, without citation or analysis of this Court's controlling decisions in *Kimbell Foods* and *Kamen*, has devised an unprecedented federal common law duty that intrudes into the States' traditional role as regulators of the legal profession and disrupts commercial relationships between lawyers and their clients. The court has done so at the request of a frequent litigant with a national litigation strategy, and for the avowed purpose of maximizing recoveries by that litigant, Pet. App. 15a. This reasoning is tantamount to providing a "volume discount" for a frequent customer, and the novel duty of counsel created is, in fact, a policy judgment Congress has declined to enact. It is also, as discussed below, a bad policy.

III. THE COURT OF APPEALS HAS CREATED AN UNPRECEDENTED AND UNWORKABLE DUTY OF COUNSEL

A. There is No General Duty to Investigate

"[O]f major concern to practicing lawyers is the scope of a duty of inquiry into the accuracy and reliability of

facts when rendering a legal opinion, documenting a transaction, participating in the follow-up to an examination, or generally representing a regulated client." [20] The Model Rules of Professional Conduct ("Model Rules") do not have a separate rule on this subject specifically, but relevant observations are scattered in several rules and comments.[21] The general statement most on point is in the comments to Rule 2.1:

> * * * A lawyer ordinarily has no duty to initiate investigation of a client's affairs or to give advice that the client has indicated is unwanted, but a lawyer may initiate advice to a client when doing so appears to be in the client's interest. [MODEL RULES OF PROFESSIONAL CONDUCT Rule 2.1 cmt ¶ 5.]

B. The Ninth Circuit's Federal Duty to Investigate is Ill-Conceived

The professional standards articulated by the Model Code of Professional Responsibility and the Model Rules, in their various State incarnations, impose upon the lawyer a duty, among others, of undivided loyalty to the client.[22] The lawyer must balance that duty with his

[20] *Working Group Report*, note 5 *supra*, at 181. This concern has been raised not only in receivership litigation (as in the case at bar) but also in the context of several consent orders in administrative actions brought by the Office of Thrift Supervision ("OTS") against law firms. *Id.* at 181-182.

[21] *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(a) (1983), directing a lawyer to "abide by a client's decisions concerning the objectives of representation" but subjecting the scope of representation to certain limits, most prominently the prohibition in Rule 1.2(d) against "counsel[ing] a client to engage, or assist[ing] a client in conduct that the lawyer *knows* is criminal or fraudulent" (emphasis supplied).

[22] This principle is not new. Nearly 60 years ago, a formal A.B.A. ethics opinion observed, "It cannot be proper for a lawyer to represent his client when the lawyer's own interests may tempt him to temper his efforts to promote to the utmost his client's

obligation, as an officer of the court, to uphold the law and our system of justice.[23] That balancing act forbids, for example, the lawyer from construing his duty of loyalty to the client as requiring (or permitting) counseling or aiding and abetting that client's commission of a crime or fraud.[24]

But this is a far cry from suggesting that a lawyer owes some sort of additional duty to the government when representing an IDI client that is already subject to pervasive regulation and supervision by agencies of the government.[25] Were such a duty to exist, then the lawyer would be disabled, in a potentially high percentage of engagements, from providing legal services to the client because of an inherent conflict of interest. Such a duty would, for example, require the lawyer representing an IDI in a "cutting edge" transaction to notify the regulator and seek to ascertain its position on the matter, an effort which is not, in general, required of the client or

interests." A.B.A. Comm. on Professional Ethics and Grievances, Formal Op. 132 (Mar. 15, 1935). Similarly, Canon 15 of the A.B.A. Canons of Professional Ethics stated in part, "The lawyer owes entire devotion to the interest of the client, warm zeal in the maintenance and defense of his rights and the exertion of his utmost learning and ability, to the end that nothing be taken or be withheld from him, save by the rules of law, legally applied." Canon 7 of the Model Code of Professional Responsibility likewise requires the lawyer to represent the client's interest zealously, provided this is done within the bounds of the law. *See* MODEL CODE OF PROFESSIONAL RESPONSIBILITY Canon 7, DR 7-101 (1980). At the same time, however, the rule does permit the lawyer to exercise independent professional judgment and to refuse to aid or participate in conduct that he believes to be unlawful, even though there is some support for an argument that the conduct is legal.

[23] *See, e.g., id.* DR 7-102.

[24] *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1983).

[25] In this case, ADSB was subject to regulation at *both* the federal and state levels.

the lawyer, and may not be desired by the client or even practical in view of the timing of most business transactions and the often protracted process of obtaining guidance from a government agency. Also, if the lawyer does ascertain the agency's position and finds that the agency disagrees with the client's and the lawyer's position, the lawyer will become entangled in an ethical quagmire. The Model Rules generally proscribe representing a client if the representation "may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests . . ." [26] While the rule does permit exceptions with client consent after full disclosure, that consent alone is insufficient, as the rule also requires that "the lawyer reasonably believes the representation will not be adversely affected" [27] —a judgment many lawyers will be unable to make if it is clear the government's and client's respective positions are irreconcilable.

The lawyer's position becomes even more difficult when the bounds of the duty to the government are expanded. Now the lawyer has reason to be concerned about his or her own liability if an enforcement action or malpractice claim asserting such a duty should subsequently be brought by the government. "The lawyer's own interests should not be permitted to have an adverse effect on representation of a client * * * * If the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice." [28]

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[26] Model Rules of Professional Conduct Rule 1.7(b) (1983).

[27] *Id.* Rule 1.7(b)(1)-(2).

[28] *Id.* Rule 1.7, cmt. This fear is not theoretical. The General Counsel to one of the nation's largest banking organizations told the ABA Working Group on Lawyers' Representation of Regulated Clients that, with the proliferation of cases by the banking agencies against law firms, outside counsel have begun noticeably to "pull their punches" and are no longer taking as aggressive a stance with the regulators on the bank's behalf.

Lest it be thought that these concerns are far-fetched and that the agencies would never expect this new duty to be extended so far, it should be noted that not only FDIC but other federal regulators have already suggested pushing the concept far beyond what is implicit in the factual setting of the instant case. In one recent lawsuit, FDIC claimed that the defendant law firm failed to advise not only the board of directors of its client bank but also the federal regulator, with which it was negotiating on behalf of the client, that the law firm was intensively working, at the bank's expense, on a buyout by an insider and the financial arrangements for that buyout with foreign bank clients of the firm.[29] While the firm's failure to advise the board would seem to state a claim, it is by no means clear whence a duty arises to inform the regulator.[30] Additionally, among the claims of legal malpractice advanced in this complaint is that the firm "failed to exercise independent professional judgment on behalf of the Bank *and its depositors* * * * *" [31] While no one would quarrel with the theory of this claim as it applies to the bank, the notion that counsel to the institution are also representing the depositors is hardly an accepted one.

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[29] *FDIC v. Eckert Seamans Cherin & Mellott et al.*, No. 90-0488, Complaint ¶ 42 (E.D.N.Y., filed Feb. 8, 1990). The *ad damnum* in this Complaint was $300 million.

[30] FDIC also alleged in that case that, at a meeting with the bank examiners, the firm represented that efforts would be made to address the examiners' concerns about undue risks presented by the mortgage servicing assets but failed to disclose to them its awareness that the bank had already entered into an agreement for the purchase of an additional mortgage servicing portfolio from another party. *Id.* ¶¶ 84-85. Assuming that this purchase was a normal and lawful transaction when entered into, the duty to disclose it to the examiners not only is not contemplated under current standards of professional responsibility but is affirmatively prohibited. Model Rules of Professional Conduct Rule 1.6 (1983).

[31] Eckert Seamans Complaint, note 29 *supra*, ¶ 120(h) (emphasis supplied).

Indeed, to suggest that an attorney-client relationship with a depository institution (or any corporate entity, for that matter) also entails representing some other closely identified group such as the directors, the officers, the shareholders, the depositors, or the creditors not only creates an innate conflict of interest in every case but also, and more fundamentally, ignores the separate juridical existence of the institution.[32]

Taking the concept even further, officials of the Office of Thrift Supervision (OTS) have asserted that outside counsel to a thrift institution owe a *fiduciary duty* to the federal government because of, variously, the "negative equity interest" the government holds in the institution (*i.e.*, the government as a kind of stockholder), the size of the government's stake (as the single largest creditor) in the event the institution fails, "hornbook" insurance law that an insurer who covers a loss is subrogated to the rights of the insured, and a duty of counsel to practice the "whole law." Provisions implementing this duty to the government can be found in the consent orders with the OTS signed by various law firms, including the highly publicized, $41 million Kaye, Scholer settlement of a $275 million claim.[33]

The ethical dilemmas for an IDI's counsel that simultaneously owes a duty to the client and the government can be illustrated in the most common factual setting,

[32] For examples of novel theories in other receivership cases, *see Task Force Report*, note 5 *supra*, at Part V.

[33] *See* Stephen Labaton, *Lawyers Agree to Pay Big Fine in S&L Case*, N.Y. Times, Mar. 9, 1992, at A1; Sharon Walsh, *Law Firm Settles S&L Complaint; Pact With Regulators Calls for $41 Million Payment Over 5 Years*, Wash. Post, Mar. 9, 1992, at A1. For critiques of OTS's theories and these consent order provisions, *see generally* Lawrence G. Baxter, *Fiduciary Issues in Federal Banking Regulation*, 56 LAW & CONTEMP. PROBS. 7 (1993); Keith R. Fisher, *Nibbling on the Chancellor's Toesies: A "Roguish" Concurrence with Professor Baxter*, 56 LAW & CONTEMP. PROBS. 45 (1993).

where counsel is engaged to prepare loan documentation. In this situation, counsel has been engaged for a specific purpose and is neither hired, nor in most cases qualified, to serve as regulatory counsel. Yet, if one imposes an open-ended duty to investigate, counsel might be obliged to

- ascertain whether the loan was a bona fide transaction and not a sham; [34]
- investigate the borrower and his related interests to determine whether the loan violated any of the myriad of regulatory requirements, such as restrictions on loans to insiders and their related interests, limitations on loans to one borrower, or antitying restrictions; [35]
- evaluate the IDI's financial records to determine whether it has adequate capital to book this asset; [36]
- independently evaluate the creditworthiness of the borrower, the purpose of the loan, and the adequacy of the collateral, to ascertain whether making the loan would be an unsafe or unsound practice; [37]
- determine, if the loan is secured by real property, whether the IDI has obtained an adequate and

[34] *Cf. FDIC v. Shrader & York*, 991 F.2d 216, 219 (5th Cir. 1993); *FDIC v. Bauman et al.*, No. CA3-90-614-H, Complaint ¶ 68 (N.D. Tex., filed Mar. 19, 1990).

[35] *See, e.g.*, 12 U.S.C. §§ 84, 375a, 375b, 1972; 12 C.F.R. Parts 31, 32, 215.

[36] *See, e.g.*, 12 C.F.R. Part 208, App. A-B. As lawyers are not by training or experience competent to perform this financial analytical task, the *reductio ad absurdum* would be for the law firm to hire its own accounting firm to audit the client's books.

[37] *Cf.* 12 U.S.C. § 1818(b)(1), (e)(1)(A)(ii), (i)(2)(B)(i)(II) (possible enforcement sanctions for engaging in any unsafe or unsound practice).

independent appraisal[38] and whether the IDI has in place adequate written policies and procedures for real estate lending;[39]

That the firm has not been engaged to perform (and is not competent to perform) all of that work, and that the client may be unwilling to pay for it (or, worse yet, may become irritated enough at the thought to sever the relationship), are, of course, fundamental issues going to the heart of any duty to investigate. It almost goes without saying that having this sort of work done by a law firm is frightfully expensive.[40]

Imposing on regulatory lawyers a duty to the government would result in equally expensive but considerably more deleterious consequences, for it would impair that independence and detachment which are one of the principal values of the attorney-client relationship. In view of the complex skein of statutes and regulations governing IDIs and their affiliates, bank regulatory lawyers serve an important function assisting their clients in new product

[38] *See, e.g.*, 12 C.F.R. Part 34.

[39] *See, e.g.*, 12 C.F.R. Part 208, App. C.

[40] Some important limitations on a duty to investigate may be found in the ABA's *Statement of Policy Regarding Lawyer's Responses to Auditor's Request For Information.* This Policy Statement provides in pertinent part that a lawyer's response to an auditor's inquiry "is properly limited to matters which have been given substantive attention by the lawyer in the form of legal consultation, and, where appropriate, legal representation." There is simply no duty to investigate "legal problems of the client, even when on notice of some facts which might conceivably constitute a legal problem." As further explicated in the commentary to this provision, a lawyer's response "should not include information concerning the client which the lawyer receives in another role." *See, e.g., Tew v. Arky, Freed, Stearns, Watson, Greer, Weaver & Harris, P.A.*, 655 F. Supp. 1573, 1574 (S.D. Fla. 1987) (no duty to advise auditors of client's financial problems, even though member of law firm attended meeting at which client's impending insolvency was discussed).

development and other innovations. Our balkanized system of depository institution regulation has long encouraged the identification and exploitation of what are disparagingly referred to as "loopholes." Many of these "loopholes" have proved essential in enabling the banking industry to keep pace with market developments. They also reflect deliberate compromises by Congress, which, of course, retains plenary power to plug loopholes it later finds undesirable. Some of the more well-known "loopholes" identified and exploited by sophisticated regulatory counsel in recent years have included

- the creation of "nonbank banks" by exploiting a loophole in the pre-1987 definition of "bank" in the Bank Holding Company Act, *see Board of Governors v. Dimension Fin. Corp.*, 474 U.S. 361 (1986);[41]
- construction of the Federal Deposit Insurance Act to permit the offering of federally insured brokered deposits, notwithstanding efforts by FDIC and the Federal Home Loan Bank Board to prohibit such practices by regulation, *see FAIC Securities, Inc. v. United States,* 768 F.2d 352 (D.C. Cir. 1985);
- permitting banking organizations to diversify into the securities business with the creation of bank securities affiliates engaging in underwriting and dealing in all manner of securities by exploiting a loophole in the Glass-Steagall Act, *see Securities*

[41] In *Dimension*, this Court admonished the Federal Reserve Board to police only within the bounds of its statutory authority and not usurp the legislative function by trying to correct perceived flaws in the statute it administers. The "nonbank bank" issue also serves as a good example of Congress' power—and readiness—to make such adjustments. In the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (1987), at the urging of the Federal Reserve, Congress plugged the nonbank loophole by changing the statutory definition of "bank" in the Bank Holding Company Act.

Indus. Ass'n v. Board of Governors, 900 F.2d 360 (D.C. Cir. 1990); *Securities Indus. Ass'n v. Board of Governors,* 839 F.2d 47 (2d Cir.), *cert. denied,* 486 U.S. 1059 (1988); and

- the use of State law to permit bank holding companies to engage indirectly in various aspects of the insurance business, conducted through a bank rather than a nonbank subsidiary, to avoid a prohibition against such activities in the Bank Holding Company Act, *see, e.g., Citicorp v. Board of Governors,* 936 F.2d 66 (2d Cir. 1991); *Independent Ins. Agents of America, Inc. v. Board of Governors,* 890 F.2d 1275 (2d Cir. 1989), *cert. denied,* 498 U.S. 810 (1990).

Some of these examples were bitterly contested by the agencies. The private parties all prevailed in court, but, had they not, it would not have been possible at the conclusion of the court battle for the agencies to initiate actions against counsel. The chilling effect on counsel of any manufactured federal common law duty that might lead to a contrary result is self-evident.

Lest there be any misunderstanding, nothing in this brief should be read to suggest that a lawyer may ignore, counsel, or assist violations of law or criminal or fraudulent conduct by the client, or that a lawyer may assume an ostrich-like posture and close his or her eyes to facts and circumstances which a reasonably prudent person would deem suspicious. Existing State ethical rules and principles of professional liability deal adequately with those issues. But it must be remembered that the duty imposed by the court below arises *despite the lack of any basis for suspicion.* The court is, in effect, allowing the government to deputize the private bar to do the supervisory job the regulatory agencies themselves should be doing. That is bad banking law and bad policy.

Such an open-ended rule is inappropriate. Even with respect to a matter that is unquestionably within the

scope of the lawyer's engagement, the extent of the inquiry, if any, that counsel should make ought not to be a rule of general applicability but ought instead to depend upon (A) the nature of the facts within counsel's personal knowledge or professional experience and (B) whether, based on such facts, reasonably prudent counsel should know or suspect that something is amiss.[42] The danger of an unqualified duty to investigate is that it effectively transforms counsel into an insurer of his client's good faith or of the accuracy of the facts represented to him by the client.

C. Malpractice Insurance Consequences

The impact of decisions such as the Ninth Circuit's in the instant case on the availability, cost, and coverage of legal malpractice insurance has been predictable. For several years now, most insurers have required that all renewing or prospective insureds submit supplemental information about the nature and extent of the firm's representation of financial institutions, including identification of the individual clients. This detailed information is used by the insurers not only to underwrite but also to reserve claims. Some insurers even take this information and independently research the solvency of each listed IDI client.

Some insurers are simply declining coverage (or quoting premiums so high as to be tantamount to declination) for firms with significant representation of financial institution clients. Other insurers are variously excluding coverage for claims brought against a law firm by the regulators, for the firm's banking practice entirely, for claims arising out of legal work performed for specifically identified IDIs, or for claims arising out of legal work performed by identified lawyers in the firm (*i.e.,* those

[42] For a helpful discussion of these principles in the securities law context, see Judge Friendly's opinion in *SEC v. Frank,* 388 F.2d 486 (2d Cir. 1968).

who represent IDIs). Where coverage is available, the policies exhibit increased premiums, increased deductibles, lower per claim and aggregate limits, or sublimits, well below the general policy limits, for claims arising out of financial institutions work. *See generally Working Group Report* at 48-53, 266-271.

The consequent impact on the cost and availability of legal services to IDI clients is also predictable. Even if the proliferation of claims against law firms does not, of itself, drive a number of firms currently providing legal services to IDIs out of the market, the increasing cost and diminishing availability of malpractice insurance may lead to that result. Those firms that remain will, of necessity, be forced to charge higher fees for such services and may well find it prudent not to represent IDIs in financial difficulty or with low net worth because of the increased risk of failure and subsequent searching by the receiver for every "deep pocket." Ironically, therefore, the very clients that need quality legal services the most may often be unable to find them or afford them if found. And those IDIs that can afford such services will simply pass the costs on in the form of lower interest rates on deposits, higher fees for banking services, and higher interest rates on loans. The long-term, deleterious effects on the banking industry and on consumers of financial services will far outweigh any short-term benefit to taxpayers from enrichment of FDIC's coffers.

CONCLUSION

The selection of a rule of decision according to whether a particular litigant can maximize its recoveries is not an appropriate criterion for resolving the rights and responsibilities of parties acting under an impartial body of rules. The underlying cause of action in this case was created under State law and brought by FDIC as receiver for a failed, state-chartered bank. Nothing in the Federal Deposit Insurance Act or in this Court's jurisprudence justifies the creation of a federal common law duty of counsel to investigate, and the implications of imposing such a duty to the government demonstrate beyond cavil that it is bad law and bad policy. The decision of the court of appeals should be reversed.

Respectfully submitted,

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No. 93-489

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

O'MELVENY & MYERS, a Law Partnership,
Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION AS RECEIVER FOR AMERICAN DIVERSIFIED SAVINGS BANK, ADC FINANCIAL CORPORATION, AMERICAN DIVERSIFIED/WELLS PART II, AND AMERICAN DIVERSIFIED/GATEWAY CENTER,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF *AMICUS CURIAE* OF SECURITIES INVESTOR PROTECTION CORPORATION, EUGENE W. BELL AS TRUSTEE FOR THE LIQUIDATION OF JOSEPH SEBAG, INC., AND LAURENCE A. SCHROEDER AS SUCCESSOR TRUSTEE FOR THE LIQUIDATION OF FIRST STATE SECURITIES CORPORATION, IN SUPPORT OF RESPONDENTS

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BRIEF *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

PRELIMINARY STATEMENT

The Securities Investor Protection Corporation ("SIPC"), Eugene W. Bell as Trustee for the Liquidation of Joseph Sebag, Inc., and Laurence A. Schroeder as Successor Trustee for the Liquidation of First State Securities Corporation submit this brief as *amici curiae* in support of Respondents and urge this Court to affirm the opinion and judgment of the United

States Court of Appeals for the Ninth Circuit below in *FDIC v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992).[1]

INTEREST OF AMICI CURIAE

SIPC is a non-profit membership corporation charged with the administration of the Securities Investor Protection Act, 15 U.S.C. §78aaa et seq. ("SIPA" or "the Act"). Section 78ddd of the Act established a fund from assessments on the approximately 8,000 brokerage firms that are members of SIPC. The size of the SIPC fund is more than $790 million. SIPC also is authorized to borrow up to $1 billion from the United States Treasury if SIPC's funds become inadequate to fulfill its statutory purposes. 15 U.S.C. §78ddd(f)-(h).

SIPC is charged with administering the fund to protect customers of failed brokerage firms. In the event of a firm's failure, a trustee specified by SIPC and appointed by a federal district court, and possessing powers similar to those of a trustee in bankruptcy, endeavors to replace customers' securities positions and restore cash in customers' accounts. Customers' claims are paid with advances to the trustee from the SIPC fund, to the extent that they cannot be paid promptly through liquidation of the firm's assets and recoveries from wrongdoers. The liquidation of financially troubled brokerage firms often requires that SIPC and the trustee bring actions against third parties. SIPC and the trustee thus are

[1] This brief *amicus curiae* is filed with the consent of the parties. Copies of their consents are on file with the Clerk of the Court.

involved in proceedings similar to those in the case before the Court.

Eugene W. Bell as Trustee for the Liquidation of Joseph Sebag, Inc., and Laurence A. Schroeder as Successor Trustee for the Liquidation of First State Securities Corporation (referred to collectively as "the Trustees") are duly appointed trustees in ongoing liquidation proceedings in the United States Bankruptcy Courts for the Central District of California and the Southern District of Florida, respectively. These proceedings include an action involving claims by the Trustees and SIPC against insiders of both firms as well as third-party wrongdoers. *Securities Investor Protection Corp. v. Vigman*, Number CV 83-4742 AWT (C.D. Cal. filed July 22, 1983).

The complaint in *Vigman* asserts that insiders of the firms and third party defendants committed fraud and violated RICO and federal securities law and that these acts culminated in the insolvency of the brokerage firms. The district court ruled that the Trustees may not pursue these claims, because the firms in liquidation would be barred from asserting them, due to the misconduct of the firms' insiders. Specifically, the district court held that the insiders' knowledge of wrongdoing was to be imputed not only to the firms, but also to the Trustees, and further that the imputation of knowledge establishes a defense in favor of third party defendants who committed misdeeds that resulted in the insolvency of the firms.

Petitioner in the present case relies on essentially the same theory of imputed knowledge in support of its equitable defense.

SUMMARY OF ARGUMENT

The "imputed knowledge" theory upon which Petitioner bases its equitable defense will interfere with Respondents' responsibilities. The regulatory systems established by Congress to guide the FDIC and SIPC are intended to impose the costs of wrongdoing on the wrongdoers. Imputing the knowledge of former insiders to the receiver or trustee appointed under such a regulatory system would shield wrongdoers from the consequences of their misdeeds and damage the important public interests at stake.

Even when considered solely under state law, the knowledge of former insiders should not be imputed to Respondents. The court of appeals sought to reconcile state and federal law and gave due consideration to both.

ARGUMENT

I.

THE ABILITY OF *AMICI* TO FULFILL THEIR STATUTORY RESPONSIBILITIES MAY BE HAMPERED IF THIS COURT ENDORSES PETITIONER'S "IMPUTED KNOWLEDGE" THEORY.

Petitioner argues that knowledge of the former officers and directors of the failed financial institutions should be imputed to the institution and thence to the receiver. The same imputed knowledge theory has been raised as a shield to claims brought by trustees against third-party wrongdoers in SIPC liquidation proceedings. Should the Court endorse a defense based on this theory, the effect will reach SIPA trustees and will prevent them from fulfilling their statutory responsibilities.

"Congress enacted the SIPA to . . . restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers." *SIPC v. Barbour*, 421 U.S. 412, 415 (1975). When SIPC determines that a member firm is in danger of failing to meet its obligations to customers and that there exists one or more of the conditions specified in 15 U.S.C. §78eee(a)(3),[2] SIPC may apply to a court of competent jurisdiction for a protective decree. *Id.* The district court then acquires exclusive jurisdiction over the SIPC member firm and its property, wherever located. *Id.* §78eee(b)(2). SIPC may specify a trustee who shall be appointed by the court. *Id.* §78eee(b)(3). "The trustee is empowered and directed by the Act to return customer property, complete open transactions, enforce rights of subrogation, and liquidate the business of the member. . . ." 421 U.S. at 417. The proceedings conducted by the trustee are directed at the goal of the Act itself: "to afford protection to public customers in the event broker-dealers with whom they transact business encounter financial difficulties and are unable to satisfy their obligations to their public customers." *SEC v. Alan F. Hughes, Inc.*, 461 F.2d 974, 977 (2d Cir. 1972).

Critically important to this regulatory goal is the ability of SIPC and the trustee to pursue claims

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[2] The *Barbour* decision referred to sections of SIPA as they existed prior to the amendment of SIPA in 1978. The sections of SIPA referred to herein are to the amended statute and are not substantially changed from the sections referred to in *Barbour*.

against the individuals who caused the brokerage firm to fail. The trustee is authorized under section 78fff(g) to receive assignments of claims from customers in such form as the trustee determines. The trustee's general powers also permit him or her to litigate claims on behalf of the corporation. *See FDIC v. McSweeney*, 976 F.2d 532, 540 (9th Cir. 1992) (FIRREA's creation of federal cause of action does not limit availability of state law claims), *cert. denied*, — U.S. —, 124 L. Ed. 2d 658 (1993); *Koch Refining v. Farmers Union Central Exchange, Inc.*, 831 F.2d 1339, 1344 (7th Cir. 1987) (bankruptcy trustee may assert state law claims that could be asserted by corporation or shareholders derivatively), *cert. denied*, 485 U.S. 906 (1988).

The litigation of such claims by SIPC and the trustee is important because, once the customers of the failed firm have been made whole, they have no incentive to pursue the wrongdoers and likely have no standing as well. SIPC and the trustee must hold the wrongdoers liable, or else no one will, and the wrongdoers will go scot-free. Even though the customers have been compensated, this outcome would thwart the "unequivocal Congressional intent to protect the public" that is expressed in SIPC. *In re Donald Sheldon & Co., Inc.*, 153 B.R. 661, 666 (Bankr. S.D.N.Y. 1993). "To the extent that recoveries against wrongdoers are diminished, the assessments against broker-dealers and the costs of investment increase, reducing its attractiveness and impairing the financial health of the nation." *Id.* at 667. *See also, In re Application of Executive Secs. Corp.*, 702 F.2d 406, 410 (2d Cir.), *cert. denied*, 464 U.S. 818 (1983) ("Although not formally part of the federal government,

SIPC and its trustees vindicate important public interests.")

This Court previously has recognized the importance of the Trustees' ability to bring such claims. In *Holmes v. SIPC*, 503 U.S. —, 112 S. Ct. 1311, 117 L. Ed. 2d 532 (1992), the Court rejected an attempt by SIPC to bring certain claims directly against third parties in that case. The Court's reasoning depended on the Trustees' ability to pursue such claims: "[T]hose directly injured, the broker-dealers, [can] be counted on to bring suit for the law's vindication. . . . [T]he broker-dealers have in fact sued in this case, in the person of their SIPA trustees appointed on account of their insolvency." 503 U.S. at —, 117 L. Ed. 2d at 547.

The *Holmes* decision was rendered in a case being litigated by the present *amici*. On remand to the district court, the Trustees continued to litigate their claims against third party defendants. However, the district court recently granted summary judgment to certain of those defendants on the grounds that the knowledge of insiders of the failed brokerage firms must be imputed to the firms and to the Trustees themselves. The district court adopted the position recommended by Petitioner in the present case. This imputed knowledge theory has prevented the Trustees from holding third parties accountable for their misdeeds and will prevent the vindication that this Court anticipated in *Holmes*.

In the present case, the imputed knowledge issue arises in the context of an equitable estoppel. However, the potential defenses based on imputed knowledge are legion. Third party wrongdoers could assert other affirmative defenses, such as indemnification or

contributory negligence. *See Comeau v. Rupp*, 810 F.Supp. 1127, 1142-43 (D. Kan. 1992). Imputed knowledge also could be used to attack reliance, causation, or some other element of the cause of action that the trustee or receiver otherwise could prove; the third party wrongdoers used this tactic in *SIPC v. Vigman*. Third party wrongdoers also could attack the standing of the trustee or receiver. *See Kempe v. Monitor Intermediaries, Inc.*, 785 F.2d 1443, 1444 (9th Cir. 1986) (per curiam).

The imputed knowledge theory could be used to disable trustees and receivers seeking to recover the looted assets of failed brokerage firms and financial institutions, thus relieving wrongdoers of the costs of their misdeeds. This Court should not endorse a theory that would permit such results.

II.

THE COURT OF APPEALS' JUDGMENT MAY BE AFFIRMED ON STATE LAW GROUNDS.

Petitioner interprets the judgment of the Court of Appeals for the Ninth Circuit as creating a conflict between federal law and state law. If a conflict exists, *amici* agree with Respondents and respectfully urge this Court to resolve it in favor of affirming the judgment below. However, *amici* believe that the judgment of the court of appeals serves the objectives of state tort law and gives proper weight to the long-recognized responsibilities of receivers and trustees charged with administration of a regulatory scheme. This position is consistent with Respondents' argument that federal law supports affirmance. *Amici* and Respondents rely on some of the same court decisions in presenting these complementary arguments.

The FDIC represents the public. The statutes governing the FDIC's powers and authorities "should be given a practical construction, and one which will enable the agency to perform the duties required of it by Congress." *FDIC v. Sumner Financial Corp.*, 451 F.2d 898, 904 (5th Cir. 1971), *reh'g denied*; *Comeau*, 810 F.Supp. at 1142; *Resolution Trust Corp. v. Youngblood*, 807 F.Supp. 765, 771-72 (N.D. Ga. 1992).

As the court of appeals below properly ruled, important federal interests should not be sacrificed when a conflict with state laws arises. However, the court of appeals attempted to reconcile state and federal law, as it has in other cases, by rendering a decision that gives due respect to the aims and priorities of both. *See, e.g.*, *FDIC v. McSweeney*, 976 F.2d at 538-40 (FIRREA's creation of cause of action against officers and directors of financial institutions for gross negligence does not limit FDIC's authority to bring state law claims that require lesser showing of fault); *Home Savings Bank, F.S.B. v. Gillam*, 952 F.2d 1152, 1156-57 (9th Cir. 1991) (RTC's general statutory authority to put insured institutions in sound and solvent condition defeats argument that bank may not sue its former officers and directors).

The United States Court of Appeals for the Seventh Circuit has applied a similar analysis. In *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982), the court considered the twin objectives of tort law to "compensate the victims of wrongdoing and to deter future wrongdoing." 686 F.2d at 455. The court recognized that permitting a corporation to hold its auditors liable for misconduct in which the corporation's own former management participated would serve neither of these goals, be-

cause any recovery would accrue to the benefit of the corporations's shareholders, who had failed to detect the former management's misdeeds. *Id.* at 456.

In a later case, the court considered these same objectives of tort law in a situation similar to that presented in the case at bar. In *Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983), the Illinois Director of Insurance brought claims as liquidator of a failed firm against the firm's former accountants and others. The court recognized that the tort objectives stated in *Cenco* would be served by permitting the Director to pursue those claims. 711 F.2d at 1348-49.

Like the Illinois Director of Insurance in *Schacht*, the FDIC in the present case is appointed under the authority of a regulatory statute and is endowed with a public mission. The public interests at stake are more important than the purely private interests considered in *Cenco*, or in cases involving claims by the trustee of a debtor's estate in bankruptcy. *See, e.g.*, *In re Investors Funding Corp. of New York Securities Litig.*, 523 F.Supp. 533, 540-41 (S.D.N.Y. 1980). As *Schacht* illustrates, the key consideration is not whether a receiver or trustee wields federal statutory authority, but whether the receiver or trustee is bringing its claims in furtherance of a regulatory system designed to protect the public interest. Both state and federal law should be interpreted to vindicate the public interests at stake, to compensate victims, to impose the costs of wrongful acts on those who committed the acts, and to deter future wrongdoing. The court of appeals did so in the present case, and the judgment should be affirmed.

CONCLUSION

For the foregoing reasons, the judgment of the United States Court of Appeals for the Ninth Circuit should be affirmed.

Respectfully submitted,

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February 18, 1994